Current Estate and Income Tax Topics

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Current Estate and Income Tax Topics

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I. TRANSFER TAXATION

A. No "Clawback"

Proposed Reg. § 20.2010-1(c), REG-106706-18, 83 Fed. Reg. 59343 (November 23, 2018)

In response to IRC § 2001(g)(2), enacted as part of the 2017 Tax Act, in which the Secretary of the Treasury is directed to prescribe regulations to carry out IRC § 2001(g) with respect to the difference between the basic exclusion amount applicable at the time of a decedent's death and the basic exclusion amount applicable with respect to any gifts made by the decedent, the Secretary issued Proposed Reg. § 20.2010-1(c).

Proposed Reg. § 20.2010-1(c) is intended to ensure that, if a decedent uses the increased basic exclusion amount for gifts made while the 2017 Tax Act was in effect and dies after the sunset of the 2017 Tax Act (currently scheduled for January 1, 2026), such decedent will not be treated, on such decedent's estate tax return, as having made adjusted taxable gifts solely because the increase in the basic exclusion amount effectuated by the 2017 Tax Act was eliminated.

The mechanism by which Proposed Reg. § 20.2010-1(c) would achieve this result is to provide that, if the total of unified credits that were used in computing a decedent's gift tax on post-1976 gifts is greater than the unified credit that would be used, pursuant to IRC § 2010(c), to compute the estate tax on the decedent's estate, the credit that can in that circumstance be used to compute the estate tax is deemed to be the total of unified credits that were used in computing the decedent's gift tax.

This is a not unexpected, but nevertheless welcome, development.

B. Tax Court Refuses to Reduce Marital Deduction by Estate Taxes Payable Because of Inclusion in Estate of FLP Interests

Estate of Turner v. Commissioner, 151 T.C. No. 10 (November 20, 2018)

1. *Facts*

Clyde W. Turner, Sr. and his wife, Jewell, acquired Regions Bank stock throughout their lives. By 2002, they owned more 170,000 shares of Regions Bank stock. Mr. and Mrs. Turner also maintained several bank and investment accounts and held real estate interests in Georgia and North Carolina.

On April 15, 2002, Mr. and Mrs. Turner established Turner & Co. as a Georgia limited liability partnership. Mr. and Mrs. Turner each owned a 0.5% general partner interest and a 49.5%

limited partner interest. Later in 2002, Mr. and Mrs. Turner each contributed assets to Turner & Co. with a fair market value $4,333,671, for a total value of $8,667,342. These assets consisted of cash, Regions Bank stock, shares of stock from three other banks, three certificates of deposit and four brokerage accounts.

On December 31, 2002 and January 1, 2003, Mr. and Mrs. Turner gave limited partner interests in Turner & Co. to their three children and to two of their grandchildren. A valuation of these interests was completed on May 18, 2004 that stated that the interests transferred on December 31, 2002 and January 1, 2003 had values of $1,652,315 and $474,315, respectively. After these transfers, Mr. and Mrs. Turner each owned a 27.8% limited partner interest in Turner & Co., their three children each owned 10.8% limited partner interests and the two grandchildren each owned 5.5% limited partner interests. Mr. Turner established a trust to hold the interest of one of the grandchildren, Rory Crumley, because of Mr. Crumley's addiction to illegal drugs.

Mr. Turner predeceased Mrs. Turner on February 4, 2004. In *Turner v. Commissioner*, T.C. Memo. 2011-209 (August 30, 2011), the Tax Court ruled that the value of the assets Mr. Turner had transferred to Turner & Co. was included in his gross estate under IRC §§ 2035, 2036(a)(1) and (a)(2). In *Turner v. Commissioner*, 138 T.C. No. 14 (March 29, 2012), the Tax Court held that, although under Mr. Turner's Will a marital deduction formula directed that a QTIP trust receive assets equal to the amount necessary to reduce the estate taxes to zero, the estate was not entitled to claim the marital deduction with respect to partnership interests transferred to Mr. Turner's descendants or the assets represented by the transferred partnership interests.

2. *IRS Position and Tax Court Ruling*

In the instant case, the Internal Revenue Service observed that all assets remaining to be disposed of and out of which the estate's estate tax liability could be satisfied were assets directed by Mr. Turner's Will to pass to the QTIP trust. Therefore, the Service reasoned, to the extent such assets were used to pay estate taxes, the marital deduction must be reduced. The Tax Court disagreed and ruled that the original marital deduction would remain intact because, to the extent the executor used assets that would otherwise have passed to the QTIP trust to pay estate taxes, the executor would have a right of recovery under IRC § 2207B.

The Tax Court's conclusion is a head-scratcher in at least a couple of respects. First, some of the estate taxes that were due from Mr. Turner's estate were state estate taxes, and IRC § 2207B does not confer on an executor a right of recovery with respect to state estate tax. Thus, arguably, the marital deduction should have been impacted by state estate tax payable. Second, presumably, the IRC § 2207B right of recovery the Tax Court had in mind was a right to recover against the recipient of the transfer that gave rise to IRC § 2036 inclusion, *i.e.*, the FLP. Some of the equity of the FLP composed assets remaining in Mr. Turner's estate with respect to which a marital deduction was being allowed by the Tax Court.

C. Family Limited Partnership Interest Discount for Lack of Marketability, but Not for Lack of Control, Allowed

Estate of Streightoff v. Commissioner, T.C. Memo 2018-178 (October 24, 2018)

1. *Facts*

On October 1, 2008, Frank Streightoff formed a family limited partnership (the "FLP") with several family members as well as a revocable trust. Frank received an 89% limited partner interest, which he immediately assigned to the trustee of his revocable trust. The partnership agreement provided that limited partners owning a 75% or greater limited partner interest could, among other things, approve the admission of additional limited partners, remove the general partner (which would terminate the partnership) reconstitute the partnership and elect a new general partner.

In valuing the 89% interest for federal estate tax purposes, Frank's estate asserted that the 89% interest was an assignee interest and claimed a 13.4% lack of control discount and a 27.5% lack of marketability discount. The Internal Revenue Service ("IRS") countered by characterizing the 89% interest as a limited partner interest giving rise to no lack of control discount and an 18% lack of marketability discount.

2. *Analysis*

The Tax Court explained that the 89% interest was a limited partner interest – both in form and in substance. Not only did the assignment paperwork indicate that the decedent had conveyed to his trust all of his 89% interest and "all and singular the rights and appurtenances thereto in anywise belonging," but the decedent, up to the moment of his death, could have revoked his transfer to his trust of the 89% interest, which would have caused the 89% interest to be held by the decedent undeniably as a limited partner interest. Accordingly, the Tax Court ruled there was no valuation discount for lack of control.

Since Frank's estate had offered no evidence as to valuation of the 89% interest as a limited partner interest, the Tax Court accepted the IRS' valuation expert's conclusion that an 18% discount for lack of marketability should be allowed.

Though Frank's surviving family members were surely disappointed in the Tax Court's decision, clearly the estate could have suffered a much worse fate, and, indeed, it is surprising the estate fared as well as it did. In *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017), a reviewed Tax Court opinion and the most recent case addressing the estate tax consequences of FLP interests since *Streightoff*, the court ruled that the entire, undiscounted net asset value of an FLP was to be included in the decedent's gross estate under Internal Revenue Code (IRC) Section 2036(a)(2) because the decedent, up to the moment of her death, could have joined with all the other partners and dissolved the FLP and, through her effective control of the general partner, could have controlled FLP distributions. One is left to wonder whether *Streightoff* is an anomaly in light of *Powell* or the IRS and the Tax Court aren't prepared, after all, to use *Powell* as the standard against which all future cases involving estates holding FLP interests are to be judged.

D. No Incidents of Ownership on Modified Trust's Purchase of Life Insurance
PLR 201919002 (May 10, 2019); PLR 201919003 (May 10, 2019)

1. *Background*

Settlor created an irrevocable trust for the benefit of Child 1 and Child 1's descendants. The trust instrument named Child 1 as Trustee and authorized the Trustee to own or acquire life insurance on the life of any person in which the trust or its beneficiaries may have an insurable interest. Child 1 also had a testamentary, special power of appointment over all assets contained in the trust.

Trustee proposed purchasing a life insurance policy on the joint lives of Child 1 and Spouse. However, since the trust instrument provided Child 1 with a testamentary, special power of appointment over all assets contained in the trust, a life insurance policy on the life of Child 1 created a risk that the life insurance death proceeds would be included in Child 1's gross estate for federal estate tax purposes upon Child 1's death.

Trustee petitioned a court to modify the trust in three ways: (1) remove Child 1's testamentary, special power of appointment over any life insurance policy on Child 1's life or the proceeds of such policy; (2) add an Insurance Trustee, who would have sole authority over insurance policies on Child 1's life purchased by the trust; and (3) require premium payments on life insurance policies on Child 1's life be paid from trust corpus. The court issued a Final Judgment of Modification, approving the modification of the trust. Accordingly, Child 2 was appointed as Insurance Trustee and purchased a second-to-die policy on the lives of Child 1 and Spouse.

A ruling was requested regarding the federal estate tax consequences of the purchase by Insurance Trustee of a life insurance policy on the life of Child 1.

2. *IRS Ruling*

The IRS determined that, prior to the trust modification, Child 1 possessed all incidents of ownership in any life insurance policy on Child 1's life that the trust may acquire. The modifications to the trust restricted Child 1's testamentary power of appointment to change the beneficial interests in the proceeds of the life insurance policy on Child 1's life. When the Insurance Trustee purchased a life insurance policy on Child 1's life, Child 1 did not possess and did not have the power to exercise any incidents of ownership in the policy acquired by trust, and the proceeds of any policy on Child 1's life would not be includible in Child 1's gross estate.

E. Appointment of Independent Trustee to Alter General Power of Appointment Will Not Give Rise to Gift or Estate Taxes
PLR 201845006 (November 9, 2018)

In this ruling, the Trustee of an irrevocable trust had discretion to distribute income and principal to the primary beneficiary during such beneficiary's lifetime. The primary beneficiary held a testamentary general power of appointment. The permissible appointees were the primary beneficiary's creditors and descendants. The trust document also appointed an independent special Trustee, who had the power to: (1) create a testamentary general power of appointment in any of

grantor's descendants, (2) convert a general power of appointment to a nongeneral power and (3) eliminate a power of appointment in whole or in part.

The trust did not have an independent special Trustee because the individual designated as such declined to serve. The other Trustees were beneficiaries. The trust document did not provide a procedure for designating another independent special Trustee.

The beneficiaries obtained a court order modifying the trust document to appoint an independent special Trustee. The beneficiaries then requested a ruling from the IRS that: (1) the appointment of the independent special Trustee would not constitute the exercise or release of a general power of appointment that would give rise to a taxable gift by the primary beneficiary and (2) the exercise of the independent special Trustee's powers to limit or eliminate the primary beneficiary's testamentary general power of appointment will not constitute the exercise or release of a general power of appointment that causes inclusion in the primary beneficiary's gross estate under IRC § 2041(a)(2).

The exercise or release of a general power of appointment is deemed a taxable gift. IRC § 2514(b). Moreover, under IRC § 2041(a)(2), a power released by a powerholder during his or her lifetime is subject to estate tax upon his or her death if the release is of such a nature that, if it were a transfer of property owned by the decedent, the property would be includible in the decedent's estate under IRC §§ 2035-2038.

The IRS granted the requested rulings. The IRS stated that the modification and the appointment of the independent special Trustee does not change or transfer the interests of the primary beneficiary during his lifetime, nor does it confer any new rights to any beneficiaries. Since the exercise of the power of appointment would occur, if at all, at the primary beneficiary's death, he retained the same interest in the trust both before and after the modification.

Thus, the IRS concluded that the appointment of the independent special Trustee will not constitute the exercise or release of a general power of appointment, and therefore would not be a taxable gift by the primary beneficiary, under IRC § 2514. In addition, the exercise of the independent special Trustee's powers regarding the power of appointment will not constitute the exercise or release of general power of appointment under IRC § 2041(a)(2).

II. INCOME TAXATION

A. United States Supreme Court Holds That State Statute That Taxed Undistributed Trust Income Solely Based on Residence of Beneficiary Violates Due Process Clause As Applied

North Carolina Dept. of Revenue v. Kimberly Rice Kaestner 1992 Family Trust, 139 S.Ct. 2213 (June 21, 2019), *aff'g*, 814 S.E.2d 43 (N.C. 2018)

1. *Facts*

Joseph Lee Rice, III (the "Settlor"), a resident of New York, created the Joseph Lee Rice, III Family 1992 Trust (the "Family Trust") for the benefit of his children. William B. Matteson, also a resident of New York, served as the initial Trustee. The trust agreement provided that the Family Trust was to be governed by the laws of the State of New York. In 1997, Kimberley Rice

Kaestner ("Kaestner"), one of the Settlor's children, moved to North Carolina. William B. Matteson resigned as Trustee in 2005, and David Bernstein ("Bernstein"), a Connecticut resident, became Trustee.

In 2006, pursuant to the terms of the Family Trust Agreement, Bernstein divided the Family Trust into three separate trusts for each child. One of the separate trusts was the Kimberley Rice Kaestner 1992 Family Trust (the "Kaestner Trust"). The Kaestner Trust benefited Kaestner as well as her three children, each of whom resided in North Carolina from 2005 to 2008, the tax years at issue. The contingent beneficiaries of the Kaestner Trust were Kaestner's siblings, none of whom resided in North Carolina.

From 2005 to 2008 the Kaestner Trust's assets were held by a custodian in Boston, Massachusetts. The ownership documents for some of the assets were located in New York, along with financial and legal records. Tax returns and trust accountings were all prepared in New York. The Kaestner Trust provided that all income and principal distributions from the trust were in Bernstein's discretion. Neither Kaestner nor her children received distributions from the Kaestner Trust between 2005 and 2008. However, two loans were made from the Kaestner Trust during the same period: a $250,000 loan was made to Kaestner for an investment and another loan was made to a separate trust "to enable [the trust] to make a capital call on a limited partnership interest" held in that trust. Both loans were eventually repaid to the Kaestner Trust. Kaestner and Bernstein communicated regularly regarding Kaestner's need for distributions and investment of the trust assets. In 2009, Bernstein transferred the Kaestner Trust assets to a new trust, the KER Family Trust.

Each year, from 2005 to 2008, the North Carolina Department of Revenue (the "State") taxed the Kaestner Trust on its income. The Kaestner Trust paid the taxes and sought a refund for the taxes paid, which the State denied in 2011. Section 105-160.2 of the North Carolina statutes provides, in relevant part, that the state may tax the income of a trust "that is for the benefit of a resident of [North Carolina]." The Kaestner Trust sued, alleging that this statute was unconstitutional under the Due Process Clause of the United States Constitution as well as Article I, Section 19 of the North Carolina Constitution. The trial court, the North Carolina Court of Appeals and the Supreme Court of North Carolina ruled in favor of Kaestner Trust. The State appealed to the United States Supreme Court, which granted certiorari on January 11, 2019.

2. *Analysis*

For a state tax to comply with the Due Process Clause, the court must first determine that there is "'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'" If such link or connection exists, then the "'income attributed to the State for tax purposes must be rationally related to values connected to the state.'" *Quoting Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), *overruled on other grounds, South Dakota v. Wayfair, Inc.*, 138 S. Ct. 735 (2018).

The court explained that in prior cases dealing with the constitutionality of state trust taxes under the Due Process Clause, when analyzing the trust beneficiary's contacts with the state, it "has focused on the extent of the in state beneficiary's right to control, possess, enjoy, or receive

trust assets." *Citing Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U.S. 83 (1929); *Brooke v. Norfolk*, 277 U.S. 27 (1928).

The court found that Kaestner Trust did not have the minimum relationship with the Trust property to justify the State's tax under the Due Process Clause. The court emphasized that, during the tax years at issue, the beneficiaries did not receive any income from the trust; they had no right to demand trust income or otherwise control, possess or enjoy the trust assets; and the beneficiaries "could not count on necessarily receiving any specific amount of income from the Trust in the future."

Thus, the court narrowly held as follows:

> We hold that the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain ever to receive it. In limiting our holding to the specific facts presented, we do not imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here.

Since the court determined that there was an insufficient connection to justify the tax under the first prong of the test under *Quill*, the court did not address the second prong of the test.

The court emphasized that its holding is limited only the specific facts presented. It stated that it would not decide "what degree of possession, control, or enjoyment would be sufficient to support taxation" when the tax is based on a trust beneficiary's in-state residence. The court also stated that it would not address "whether a different result would follow if the beneficiaries were certain to receive funds in the future." The court further stated that its decision "does not address state laws that consider the in-state residency of a beneficiary as one of a combination of factors, that turn on the residency of the settlor, or that rely only on the residency of noncontingent beneficiaries."

Justice Alito filed a concurring opinion "to make clear that the opinion of the Court merely applies our existing precedent and that its decision not to answer questions not presented by the facts of this case does not open for reconsideration any points resolved by our prior decisions," namely, *Safe Deposit* and *Brooke*.

III. TRUSTS AND ESTATES-RELATED ITEMS IN THE PRIORITY GUIDANCE PLAN

Office of Tax Policy and Internal Revenue Service, 2018-2019 Priority Guidance Plan, Fourth Quarter Update (August 28, 2019)

A. New Guidance

The IRS intends to issue new guidance regarding the following provisions:

- A Revenue Ruling under IRC § 102 regarding whether contributions of money received through a crowdfunding site to pay for medical expenses under IRC § 213 are excludable from income because the contributions are gifts.

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- IRC § 529A, regarding qualified ABLE plans.

- IRC § 1014, regarding the basis of grantor trusts at the grantor's death.

- IRC § 2053, regarding personal guarantees and the present value concepts in determining the deductible amount of expenses and claims against the estate.

- IRC § 4941, regarding a private foundation's investment in a partnership in which disqualified persons are also partners.

- IRC § 7520, regarding the use of actuarial tables in valuing annuities, interests for life or terms of years and remainder or reversionary interests.

B. Final Regulations

The IRS intends to issue final regulations under the following provisions:

- IRC § 469(h)(2), regarding limited partners and material participation.

- IRC § 509(a)(3), regarding supporting organizations.

- IRC §§ 1014(f) and 6035, regarding basis consistency between an estate and a person acquiring property from a decedent.

- IRC § 1411, regarding the net investment income tax.

- IRC § 2032(a), regarding the imposition of restrictions on estate assets during the six-month alternate valuation period.

- IRC § 2642(g), describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption.

IV. TRUST AND ESTATE ADMINISTRATION AND LITIGATION

A. Trustee Found to Have Breached its Fiduciary Duty When it Disregarded a Trust's Retention Provision in Favor of Diversification

Matter of Trust of Post, 2018 WL 3862756 (N.J.Super.A.D. Aug. 15, 2018)

1. *Facts*

Ray D. Post ("Ray") created an irrevocable trust in 1975 (the "Trust"). Ray owned and operated a fuel oil distribution business in Newark, New Jersey, was a professional and personal customer of Peoples National Bank & Trust Company of Belleville ("Peoples"), and at one time serve on its Board of Directors. Peoples served as Trustee of the Trust, which held 2,550 shares

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of common stock of AT&T, 304 shares of Exxon Corporation and a $4,500 AT&T bond. The total value of the Trust's assets was $156,550.25.

The Trust Agreement contained a retention provision that stated that the Trustee was to retain, without liability for loss or depreciation, the property received from the Grantor. The Trustee was to pay income to Ray during his life, and upon his death, income to Ray's wife, Enid. Upon Enid's death or remarriage, the Trustee was directed to distribute the remainder of the Trust assets to Ray's granddaughters, Deborah and Sarah.

Ray died in 1989. In 1993, Peoples was acquired by Valley National Bank ("Valley") and Valley became Trustee. At that time, the Trust totaled $157,436.86 and consisted of 2,600 shares of AT&T, 2,342 shares of Exxon and 7,000 shares of companies that had been created as a part of AT&T's divesture. In 2000, Valley's in-house counsel wrote a memo addressing a concern about whether the Trust was adequately diversified given the enactment of the Prudent Investor Act in 1997 (the "Act"). Valley's counsel recommended that if Valley chose to diversify, it could notify the beneficiaries of their plans and "seek out their consent or other points of view." Upon the advice of outside counsel, Valley determined that the Trust's retention provision did not relieve Valley of its duty to diversify the portfolio. Valley began diversifying the trust's portfolio, selling shares of Exxon and acquiring additional stock without approval or notice to the Court, Enid or the granddaughters.

Enid died in 2008, which triggered Valley's obligation to distribute the Trust assets to Deborah and Sarah. Valley sent Deborah and Sarah a copy of the Trust Agreement (the first time the granddaughters had seen a copy of the Trust Agreement) and a listing of the Trust's assets.

Valley reported values of the Trust as follows: $1,431,869.06 in 2001, $1,084,988.51 in 2006, $1,286,678.88 in 2007 and $1,218,556 in 2008. Following Enid's death, and for several years after, Valley made repeated requests on the granddaughters to approve a final accounting for Valley to conclude its termination of the trust, however, the granddaughters never responded. Valley ultimately prepared a final accounting of the Trust in 2011, and stated the final value of the Trust was $901,578.73. Approximately $563,000 was in a cash management account from 1993 to 2011 and the balance was in stocks and mutual funds. On March 19, 2012, Valley filed a complaint to approve a final trust accounting and to be discharged as Trustee. Deborah filed an answer taking exception to the accounting. Deborah subsequently read the Trust Agreement in its entirety and, for the first time, noticed the retention provision. Deborah amended her answer to add a counterclaim for breach of fiduciary duty, negligence, conversion and breach of the implied duty of good faith and fair dealing. She claimed over $900,000 in losses. Sarah made similar court filings.

2. *Analysis of the Trial Court*

The trial court granted Valley's motion for summary judgment on all counts except for the breach of fiduciary duty and the implied covenant of good faith and fair dealing claims. The trial court then held a trial on those issues and found in favor of the granddaughters and found that Valley breached its fiduciary duty to the beneficiaries when it diversified the trust's corpus in contravention of the Trust's retention provision.

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The court rejected Valley's contention that because of sale of the original Exxon stock and AT&T's divesture, that, in itself, was a diversification that then permitted Valley to diversify as it chose. With regard to the Act, the court rejected Valley's argument that the statute superseded the settlor's intent expressed in the retention provision. The court also concluded that as to Valley's "standard of conduct," Valley breached its duty to the granddaughters by not following the advice of counsel and seeking their approval before diversifying and failing to keep them apprised of the status of the trust corpus. As Trustee, Valley had a duty to keep the beneficiaries reasonably informed and years went by without any information to the granddaughters. Ultimately the court concluded that there was a breach of Valley's fiduciary duty but did not find that Valley acted in bad faith, so it dismissed the granddaughters' claim for violation of the covenant of good faith and fair dealing.

The court held a separate trial as to damages based upon what the value of the portfolio should have been had the retention provision been honored as compared to its actual value. Both Valley and the granddaughters had expert witnesses testify as to the estimated value of the trust had Valley not diversified, and the court ultimately agreed with the accounting submitted by Valley. It entered a judgment in favor of the granddaughters in the amount of $520,548.

3. *Analysis of the Appellate Court*

On appeal, Valley argued that the trial court ignored facts and issued erroneous conclusions of law, and that the court misapplied the Act by holding the retention provision took precedence over the Act's mandate to diversify. The appellate court disagreed. The court noted that the Act mandates diversification unless the fiduciary reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying. In other words, despite the Act's mandate, the grantor's intent controls, and if there is any doubt as to intent that should be addressed with the court. The court found here that Ray's clear intent was that he directed Peoples, as the original Trustee, to retain the stock he deposited and specifically insulated the Trustee from liability if a claim was ever brought for failure to diversify. The retention provision was not optional. Again, if Valley had questioned the retention provision and wanted to diversify, it was obligated to seek authorization from the court prior to selling trust assets. Valley was even warned of this duty by its in-house counsel, however, Valley chose to act at its own peril. The court again dismissed Valley's contentions that passive changes to the portfolio (with the spin offs and mergers of the original company stocks owned by the trust) voided the retention provision. The court also declined to interfere in the trial court's outcome on the award of damages.

B. Trustee Did Not Breach its Fiduciary Duty to Diversify Assets When Relying on a Co-Trustee with Investment Expertise Who Rejected Suggested Diversification

Matter of Wellington Trusts, 2018 WL 4905399 (N.Y.A.D. 2 Dept., Oct. 10, 2018)

Sarah P. Wellington ("Sarah") was the beneficiary of two trusts under which JPMorgan Chase Bank, N.A. ("JPMorgan") was a Trustee. The first trust ("Trust 1") was executed in 1961 by Sarah's grandfather Herbert G. Wellington ("Wellington"), who was the founder of an investment management firm. His son, Herbert Wellington ("Herbert"), worked alongside him and ultimately succeeded Wellington as president of the firm. The Trust Agreement provided that

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upon Wellington's death, the trust would be divided into equal shares for Wellington's two children: Herbert and Thomas ("Thomas") Wellington. Herbert served as a Co-Trustee. Upon Thomas' death, the principal of his trust was to be divided into separate shares for his four children, including Sarah. The second trust ("Trust 2") derived from two testamentary trusts of which Thomas was the beneficiary under Wellington's Will. Under both trusts, the Trustees were permitted to exercise their discretion to purchase or acquire securities as they deemed advisable, and permitted Herbert to remove the corporate Trustee at any time and for any reason. JPMorgan served as Co-Trustee of Trust 1 and sole Trustee of Trust 2. As Co-Trustee of Trust 1, JPMorgan reviewed the performance of trust assets and tendered investment strategies to Herbert for approval. JPMorgan made several diversification recommendations that they believed were necessary to reduce overall portfolio risk. Herbert repeatedly denied consent to diversify.

In August 2003, JPMorgan and Herbert commenced proceedings to judicially settle the accounts of the two trusts. Herbert resigned as Co-Trustee of Trust 1 and died one year later, leaving JPMorgan as sole Trustee of both trusts. At that time, JPMorgan began gradually diversifying assets. Sarah objected to the accounts and claimed that JPMorgan breached its fiduciary duty to her by failing to appropriately diversify trust assets prior to Herbert's resignation in accordance with its own risk-reduction recommendations. She argued that these failures caused reduction in principal of the trusts. The trial court denied Sarah's objections and granted JPMorgan's accountings and judicially settled the accounts.

On appeal, the court agreed with the determination of the trial court. The court determined that Sarah failed to establish that JPMorgan violated the Prudent Investor Act (the "Act") and breached its fiduciary duty to her. The court noted that the Act outlines a duty to diversify assets unless the Trustee reasonably determines that it is in the best interests of the beneficiaries not to diversify, taking into account the terms and provisions of the governing instrument. The Trustee should consider the size of the portfolio, estimated duration of the fiduciary relationship, liquidity, economic conditions, expected tax consequences, among other things. The court also noted that the Act requires a standard of conduct, not outcome or performance and the rule must be determined in light of facts and circumstances at the time of a Trustee's decision. In reaching its decision, the court ultimately determined that JPMorgan's deference to Herbert's investment strategy while he was acting as Co-Trustee was made with "reasonable care, skill and caution" required by the Act. Based upon its assessment of the trust assets and anticipated risks and market conditions, JPMorgan believed that the trusts would be best served by increased diversification. The court also noted that Herbert was not a passive or lay trustee; rather, his profession was investment management. Moreover, the court found it clear that Wellington's intent in the governing instruments establishing the trusts was that Herbert retain ultimate control over the investment strategy of the trusts – Herbert had the authority to remove the corporate Trustee at any time and for any reason. Ultimately, the appellate court agreed with the trial court that JPMorgan did not breach its fiduciary duty to Sarah.

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C. Trustee Has a Duty to Keep Beneficiaries Reasonably Informed, Provide Impartial Administration, and is Responsible for Penalties Related to Late Filing and Payment of Estate Tax

In re Estate of Glenn G. Forgey, 298 Neb. 865 (Neb. February 9, 2018)

1. *Factual Background*

Glenn G. Forgey ("Decedent") died testate in 1993. He was survived by three children, Wayne (now deceased and survived by his spouse, Marvel, and three children), Bessie and Lyle. During his lifetime, Decedent transferred his property to a Trust, for which Lyle has been the sole Trustee at all relevant times. The Trust provided that the residue of the assets of the Trust would be divided into equal shares for Decedent's children, and that Lyle's share would include all common stock of a bank where Lyle was already a part owner. The Trust provided that during its administration, the Trustee would provide an annual report to the beneficiaries and would use Trust assets to pay Decedent's debts, expenses, administration costs and inheritance and estate taxes.

The Trust's federal estate tax return was timely prepared, but Lyle neglected to sign and mail it on time, missing the deadline for an IRC § 6166 election. The IRS assessed penalties and interest against the Trust amounting to $2,200,000. To pay this liability, Lyle obtained loans for the Trust, borrowing from himself and from the bank in which he and the Trust owned stock. Negotiations with the IRS allowed the Trust to deduct the interest on the loans as an administrative expense, reducing the federal estate tax liability and resulting in total damages to the trust due to the late filing of $854,803.

Lyle continued to administer the trust assets together after payment of the tax penalty, including continued operation of a cattle operation on Trust land. Decedent, Lyle and Wayne started the cattle operation prior to Decedent's death. Decedent provided the bulk of the land for the operation with no rent paid, while Lyle and Wayne each provided some land, labor, management and equipment. They split the profits from the operation with 20% to Decedent, 45% to Lyle and 35% to Wayne. Lyle continued administering the trust property in the same manner after Decedent's death. Marvel provided bookkeeping for Wayne, and testified that they settled the accounts each year without a claim against the Trust. An expert at trial opined that had the cattle operation been discontinued, the Trust would have received an additional $600,000 in net income between 1993 or 1994 and 2009.

Lyle did not make any cash distributions from the trust until 2008, at which point he distributed requested cash to Bessie for three years. He made no distributions to Marvel until she instigated this suit in 2013. The Court directed separate equal cash distributions in 2015. During this time, Lyle provided no accountings of any sort to Marvel and Bessie until 2008, at which point Lyle provided the Trust's fiduciary income tax returns through 2007. In 2013, he provided returns from 1993 to 2012. During the course of litigation, he provided accountings through 2015.

Finally, Lyle collected $65,000 on a promissory note owed to the Trust, leaving a $71,423 balance. Lyle did not attempt to collect the remaining balance, which at the time of trial had been reduced to $61,423.

Marvel brought suit in 2013, alleging breach of fiduciary duty, among other claims. Bessie joined suit. The Court determined that the Trust owed $8,503,071 to Marvel (as Wayne's heir), $8,335,521 to Bessie and $8,253,684 to Lyle. The Court further determined that because there was no mal intent, an award of attorneys' fees to any of the parties was not appropriate. All three parties appealed.

2. *Analysis*

The Court addressed a number of challenges, focusing on failure to render accountings, Lyle's liability for the increase in estate tax and benefit from the loan interest, failure to elect under IRC § 6166 which resulted in payment of avoidable tax, damages for delayed administration, nonpayment of rents, failure to collect valid debts owed the Trust, and allocation of attorney's fees.

A Trustee has a duty to administer the Trust in good faith, in accordance with its terms and the purposes and interests of the beneficiaries, and in accordance with the Trust Code. The duties under the Trust Code include loyalty, impartiality, prudent administration, protection of trust property, proper recordkeeping, and informing and reporting. *In re Conservatorship of Abbott*, 295 Neb. 510 (Neb. 2017). During the time at issue, the duty to inform required either (1) keeping the beneficiaries reasonably informed and providing an accounting on an annual basis if requested or (2) an annual report of trust property, liabilities, receipts and disbursements. The Court found that Lyle clearly violated this requirement, and that it was inappropriate that Marvel and Bessie were obligated to initiate legal action in order compel Lyle to comply with this statutory obligation.

However, the Court found that the valuation issues were more nuanced - the trial court's determination that the trust assets should be valued and divided upon the Decedent's date of death was neither arbitrary, capricious nor unreasonable, even though it lead to incidental benefit to Lyle through his use of the bank entity for a loan. The Court noted that the use of Trust land for the cattle operation without payment of rent breached a duty of impartiality and the Trust should have paid rent for its use, but found damages only for Bessie, who was unaware of the inner workings of the operation. Marvel, through her bookkeeping for Wayne, was aware that the Trust was not receiving rent, and therefore had the opportunity to object to the annual account settlement.

The Court clarified the lower court's order to assess the value of the uncollected note from Lyle's share, and offset the additional amount of IRS damages from Lyle's share as well, as his failure to timely file and make the IRC § 6166 election caused that liability.

Finally, the Court affirmed that the majority of the claims against Lyle were determined to be unfounded, and understood the lower court's reluctance to award attorney fees. However, it determined that an award of attorney fees was necessary as a penalty for Lyle's failure to report to the beneficiaries for so many years until the litigation occurred.

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D. Court Rejects Trust Modification Without Consent of All Remainder Beneficiaries

Shire v. Unknown/Undiscovered Heirs, 299 Neb. 25 (February 16, 2018)

1. *Facts*

Jennie Shire (the "Testator") created her Will in 1947, in which she created a trust for the benefit of her daughter during her daughter's lifetime, and then for the benefit of her granddaughter at her daughter's death (the "Trust"). The Trust was funded with $125,000 and would pay $500 every month to the relevant lifetime beneficiary. By 2016, the Trust's principal had reached nearly $1,000,000, and the monthly distributions to Testator's granddaughter (the "Granddaughter") were still $500, far less than the income the Trust was earning. At Granddaughter's death the remainder would be distributed to a group of beneficiaries (the "Remainder Beneficiaries"). Wells Fargo, the Trustee of the Trust (the "Trustee"), petitioned the Court to allow larger distributions to Granddaughter by modifying the Trust.

Trustee identified a group of 12 that it believed to possibly be Remainder Beneficiaries. Seven individuals appeared at the hearing, along with the Nebraska Attorney General's Office on behalf of charitable entities. The Trustee requested that the Court appoint an attorney to represent the unknown and undiscovered heirs, if any, of the Remainder Beneficiaries. The only opposition the Court received to the petition was from the counsel for the unknown beneficiaries.

The lower court denied the modification because the request did not qualify under Neb. Stat. §§ 30-3837(b), (e), or 3838. Granddaughter and Trustee appealed (their arguments will be referred to as Trustee's arguments below).

2. *Analysis*

The Supreme Court of Nebraska affirmed the decision denying the modification. The Court first looked at Neb. Stat. § 30-3837(b), which allows modification with the consent of all beneficiaries. Trustee argued that the statute only requires known beneficiaries who have common interests with the unknown beneficiaries to consent, relying on legislative history. The Court agreed that this issue is unsettled in the statute, but determined that the statute plainly says that all beneficiaries must consent, so any legislative intent is irrelevant. Furthermore, only 6 of the known beneficiaries affirmatively consented. The Court also noted that Trustee requested that an attorney be appointed for the unknown heirs.

Secondly, the Court looked at Neb. Stat. § 30-3837(e), which allows modification when the interests of nonconsenting beneficiaries would be "adequately protected." Trustee argued that "adequate" means "sufficient," whereas the unknown heirs argued that it means "absolute." Looking at the Restatement of Trusts (which the UTC corollary to this statute references), the Court determined that the intent of the statute is to protect nonconsenting beneficiaries' interests by not prejudicing those beneficiaries' interests through the modification. The Court also noted that these are the common law protections for nonconsenting beneficiaries, which the Court will protect absent plain language to the contrary in the statute. Any increase in distributions to Granddaughter would reduce the amount paid to the Remainder Beneficiaries, and therefore the

interest of the Remainder Beneficiaries could not be adequately protected by the proposed modification.

Finally, the Court rejected Trustee's argument that the Court should consider a modification under the common law doctrine of deviation. When presenting this case in lower court, Trustee erroneously relied on Neb. Stat. § 30-3838, which only applies to trusts that became irrevocable on or after January 1, 2005. Trustee therefore argued that said statute codifies the doctrine of deviation, and therefore the common law doctrine can be considered for the first time on appeal. The Court rejected this argument.

E. Court Finds That Trust Termination Contrary to Settlor's Intent

Horgan v. Cosden, 249 So.3d 683 (Fla. Dist. Ct. App. May 25, 2018), *reh'g denied* (June 29, 2018), *review denied*, 2018 WL 3650268 (Fla. July 30, 2018)

1. *Facts*

Yvonne S. Cosden (the "Settlor") created a revocable trust in 1993, and amended it several times during her life (the "Trust"). The Trust became irrevocable in 2010 at the death of Settlor. Under the terms of the Trust, the Trustees distributed $250,000 to Joseph Horgan, Settlor's friend and Co-Trustee of the Trust, and then held the remainder in trust for the lifetime of Settlor's son and the other Co-Trustee, Christopher Cosden.

The Trust's income was distributed at least quarterly to Cosden. At Cosden's death, the remainder was to be distributed to three named educational institutions. The Trust included a spendthrift provision.

In August 2015, Cosden and the educational institutions came to an agreement by which the Trust would be terminated, and each beneficiary would receive a payment of an amount that Cosden calculated. He calculated that over the term of the Trust, he would receive over $2,000,000 of the Trust's $3,000,000. The educational institutions agreed with this calculation.

Horgan would not agree to terminate the Trust, and therefore Cosden filed a petition to compel Horgan to terminate the Trust. Horgan filed a petition as well, claiming that the termination of the Trust was against the Settlor's wishes to provide lifetime income for her son. Each party filed a motion for summary judgment, and the trial court found for Cosden, based on Florida Statutes §§ 736.04113 and 736.04115.

2. *Analysis*

The Court overturned the trial court's decision, finding that the Trust could not be terminated. The Court examined the two statutes as reviewed by the trial court. The Court first looked at FSA § 736.04113, which governs trust modifications when the modification is not inconsistent with the Settlor's intent. The trial court had interpreted the statute to authorize the Trust's termination if the purposes of the Trust have been fulfilled or are wasteful. The Court then looked at FSA § 736.04115, which governs trust modifications when the continued administration per the terms of the trust is no longer in the best interests of the beneficiaries. The trial court had interpreted the statute to authorize the Trust's termination because termination would eliminate unnecessary expenses relating to the Trust.

The Court found that the Settlor intended to provide incremental income to her son, and then to distribute the remainder to the educational institutions. The Court pointed to the amendments she made before her death and the lump sum distribution to Horgan as evidence that she could have provided a lump sum to her son had she wanted to. The Court also found that the Trustee's fees all seemed normal, there was no evidence of a market risk that would jeopardize Settlor's planned gifts and there had been no invasion of principal. The Court noted that Settlor would not be required to bar termination in her Trust to express her intent that the Trust continue for her son's lifetime.

In sum, the Court found that there was no waste and that the Trust's purposes had not been fulfilled, and therefore as a matter of law there could be no termination of the Trust.

F. Co-Trustee Prohibited From Decanting When Other Co-Trustees Objected

Matter of Fund for Encouragement of Self Reliance, 440 P.3d 30 (Nev. April 25, 2019)

A charitable trust (the "Trust") had multiple Trustees, and one Trustee filed a petition to take half of the Trust's property and transfer it, through a decanting, to a new trust with identical terms. The other Trustees objected to the decanting. The terms of the Trust required that there be unanimous agreement of the Trustees in order to distribute half of the Trust corpus. Therefore, the Trustee wishing to decant had to use the power in Nevada's trust decanting statute, NRS § 163.556(1), which says in relevant part that "a trustee" with the discretion to distribute trust property to the beneficiaries may appoint trust property to a newly created trust unless prohibited by the terms of the original trust.

The lower court granted the petition to allow the Trustee to decant half of the Trust assets. The opposing Trustee appealed.

The Supreme Court overturned the decision in favor of the Trustee who wanted to decant the Trust. The Court first looked at the plain meaning of the statute, both by looking at the meaning of the words in the statute and by looking at the context. The Court held that by using the phrase "a trustee," the meaning is that given in the Nevada statutory definitions in NRS § 163.500, which is that "a trustee" means "a trustee, trustees, person or persons" with the power of a trustee. Therefore, the text of the statute refers to the Trustees of the Trust in the singular, but they still have to act within their shared Trustee office. Despite the statute referring to "a" Trustee, it still referred to the office of the "trustee," which in this case encompassed all of the Trustees.

The Court then looked at the Settlor's intent, determining that by giving power to all Trustees to act unanimously, the Settlor intended for them to act together. The Court summarized that the lack of authorization to decant within the Trust terms pushed the Trustee into relying on the statute, which then still required unanimity in this case.

G. Surrogate's Court Refused to Move Trust Situs to Facilitate Appointment of Trustee

In the Matter of the Trust for the Benefit of Andrew R. Hettrick Created Under Article SIXTH of the Last Will and Testament of Suzanne M. Hettrick, Deceased, 2018 WL 6072623, 2018 NY Slip Op 51626(U) (N.Y. Surr. November 19, 2018)

Suzanne M. Hettrick ("Suzanne") died in 2014 as a resident of New York. She was survived by three children: David, Andrew and Elizabeth. Suzanne left a Will, under which she created a supplemental needs trust for the benefit of her son, Andrew. Elizabeth and David were named Trustees of the trust. The trust instrument allowed the Trustees to distribute net income to Andrew, as well as principal as needed for Andrew's benefit, in their discretion. Upon Andrew's death, the remaining trust property was to be distributed to Andrew's then living descendants, or if none, to Suzanne's descendants. Andrew's cousin, Edward, was appointed Trust Protector of the trust, and was given the power to remove Trustees and appoint successor Trustees.

At the time of the initial filing, Andrew lived in Virginia and had no descendants. In 2017, Edward exercised his power as Trust Protector and removed David and Elizabeth as Trustees and appointed a Virginia corporate fiduciary, contingent upon the New York Surrogate's Court entering the removal order and releasing jurisdiction of the trust to Virginia. In 2018, Andrew and Edward filed a petition to transfer the trust's situs to Virginia, and David and Elizabeth subsequently objected. The Will did not authorize the change of situs of the trust from New York.

Upon cross motions for summary judgment, the court denied the transfer of situs to Virginia. The court found there was no compelling reason to warrant the transfer of the trust situs. The court noted that it may change the trust situs if it is shown to have some beneficial effect, but cannot do so simply upon a party's request, given the lack of a trust provision allowing for change of situs. The court also concluded that Andrew and Edward's desire for Andrew to be in closer proximity to the Trustee was insufficient to warrant the change in situs. The court noted that Andrew is capable of communicating with the Trustee electronically. Thus, he does not need to have in-person contact with the Trustee. Also, the court noted that Andrew resided outside of New York when the trust was created, which suggests that Andrew's place of residence was not a factor in trust situs and governing law. The court further rejected Andrew's apparent desire to have a Trustee that would never question his requests, as that is at odds with a Trustee's responsibilities. The court also rejected the argument that the remainder persons (his brother and sister) could not serve as Trustee, as that would violate the public policy of appointing relatives, instead of strangers, to administer a disabled person's trust. Additionally, the suggested successor Trustee did not have New York trust powers, which went against the Will provisions that suggested New York law was to apply to the handling of the trust.

H. Court Allows Beneficiary to Bring Claim Against Successor Trustee of Revocable Trust When Grantor Alive and Not Deemed Incapacitated

Brody v. Deutchman (In re Brody Living Trust), 2018 Mich. App. LEXIS 2971 (August 7, 2018)

Rhea Brody was the settlor of the Rhea Brody Living Trust (the "Trust"). Rhea resigned as Trustee because of diminished capacity but was never adjudicated as lacking capacity. Her husband, Robert Brody, became successor Trustee. The Trust instrument provided that, upon

Rhea's death, if Robert survived her, the Trust would be administered for Robert's benefit. Upon Robert's subsequent death, the Trust would be divided into equal shares for the benefit of Rhea's son, Jay, and Rhea's daughter, Cathy.

The Trust owned interests in two family businesses. Robert, as Trustee, entered into a series of transactions with Jay involving these interests. The transactions included granting an option to Jay to purchase a business interest and a sale of business assets to Jay on favorable terms. Cathy did not engage in any transactions involving the Trust's business interests. Cathy sued Robert for breach of fiduciary duty because he favored Jay over Cathy to the detriment of both the Trust and Cathy.

The trial court dismissed Cathy's suit for lack of standing. The Michigan Court of Appeals found that Cathy had standing despite Rhea's being alive and not adjudicated and the Trust's being revocable. The Supreme Court of Michigan disagreed and remanded the case to the Court of Appeals for reconsideration.

Under Michigan law, claims may be brought against a Trustee by an interested person. An "interested person" is a "child…and beneficiary and any other person that has a property right in or claim against a trust estate. Identification of interested persons may vary from time to time and shall be determined according to the particular purposes of, and matter involved in, a proceeding and by the supreme court rules." MCL § 700.1105(c). The Court of Appeals determined that Cathy, despite being a contingent beneficiary, qualified as an interested person by virtue of being a child of the settlor. The Court of Appeals found that the phrase "and any other person that has a property right in or claim against the trust estate" did not limit the type of child who may be an interested person. The Court of Appeals therefore affirmed its initial ruling that Cathy had standing to pursue her claims against Robert.

I. Court Rejects Claim That Communications Related to Potential Fiduciary Liability Were Subject to Attorney-Client Privilege

Morgan v. Superior Court, 23 Cal. App. 5th 1026 (May 29, 2018)

Beverly C. Morgan ("Beverly") restated the governing instrument for her revocable trust (the "Trust") in 2013. She named one of her three children, Thomas E. Morgan III ("Thomas"), as successor Trustee to serve after Beverly failed to act as Trustee.

Beverly died in 2014. Beverly's daughter, Nancy M. Shurtleff ("Nancy"), filed a petition essentially seeking to invalidate the Trust and remove Thomas as Trustee. Nancy alleged that Thomas engaged in self-dealing by using Trust funds to pay his personal lawyers and other personal expenses. The trial court suspended Thomas as Trustee and designated two non-family members, Bruce and Lee Ann Hitchman ("the Hitchmans"), as interim Co-Trustees. The court ordered Thomas to turn over all records related to the Trust, including communications with third-parties, to the Hitchmans. Thomas refused to turn over lawyer invoices and other documents related to the payment of lawyer fees, relying on a provision in the Trust instrument stating that a former Trustee may withhold from a successor Trustee all of the former Trustee's communications with legal counsel. The trial court again ordered Thomas to turn over all such documents. Thomas sought a writ of mandate and/or prohibition from the Court of Appeals relieving him from the trial court's order requiring him to turn over such documents.

The California Court of Appeals denied Thomas' writ. The court reasoned that the attorney-client privilege vests in the office of the Trustee, not in any particular person. The appellate court held that a trust instrument may not allow a former Trustee to withhold from a successor Trustee all communications between that former Trustee and his legal counsel. The Court of Appeals found such a provision violated public policy because it would "permit a trustee to intentionally (or with gross negligence or reckless indifference) violate duties with no check on his or her conduct." The Court found this provision was similar to an overly-broad exculpatory clause, such as a provision that relieves a Trustee from liability for actions taken in bad faith.

Under California law, a Trustee's communications with legal counsel regarding potential fiduciary liability may be protected by the attorney-client privilege if he retained separate counsel and paid such counsel's fees from his personal funds. *See Moeller v. Superior Court*, 947 P.2d 279 (Cal. 1997). However, there was no evidence that Thomas took any steps to separate the advice he received for his personal benefit from advice he received for trust administration matters.

J. Trust Protector Did Not Have Standing to Demand Trust Accounting
Carberry v. Kaltschmid, 2018 WL 2731898 (Cal. Ct. App. June 7, 2018)

1. *Facts*

George Dean McMillan-Gordon (the "Settlor") created a living trust in 2013, which became irrevocable at the Settlor's death in 2014 (the "Trust"). The beneficiaries of the Trust were the Settlor's spouse and children; two of the children were the Trustees. The Trust also provided for a Trust Protector. The Trust Protector had many specific enumerated powers, namely amending the Trust, construing ambiguous terms of the Trust, and the power to execute documents relating to the Trust Protector or Trustee's powers. The Trust specifically stated that the Trust Protector did not have a duty to remain informed about the Trust, or to monitor the Trustees' administration of the Trust.

In October 2015, the original Trust Protector resigned, and appointed Shaun Carberry as his successor (the "Trust Protector"). In January 2016, Trust Protector wrote to the Trustees' attorney and requested an accounting from the prior year, as well as information about certain disagreements between Trustees that had resulted in an ex parte petition being filed by one Trustee. The attorney responded that the disagreements were being resolved by a settlement and the petition had been withdrawn. In February 2016, Trust Protector reiterated his requests and asked for a copy of the settlement. The attorney responded that there were family dynamics being resolved and this resolution would inform the response to Trust Protector. The attorney also assured Trust Protector that there would not be a suit against him claiming that he did not fulfill his duties. Trustees were already delivering accountings to the beneficiaries of the Trust.

Trust Protector filed the petition in this matter in September 2016 after not receiving a response from the attorney. Trust Protector claimed that he needed an accounting from Trustees, because that he worried that there were unpaid taxes, unpaid legal fees and duplicative expenses for legal representation. A Trustee challenged the petition on the basis that Trust Protector lacked standing. The California Superior Court decided that Trust Protector did lack standing, and he appealed.

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2. *Analysis*

The Appellate Court affirmed the lower court's finding that Trust Protector did not have standing to demand an accounting. Trust Protector first argued that he was entitled to an accounting under the statute entitling beneficiaries to an accounting (California Probate Code § 16062, subdivision (a)). Rejecting this analogy, the Court further noted that the Trust Protector was not given the power to demand an accounting by the terms of the Trust, whereas the beneficiaries were. The Court rejected Trust Protector's argument that his role was functionally the same as a Trustee and therefore he had the same rights.

Trust Protector also argued that he wanted an accounting and additional information. However, the Court decided that the only "additional" information was the settlement agreement, which Trustees agreed to provide. Therefore this argument was considered moot as being too vague in the absence of any specific informational requests to which the Trustees were not responding.

K. Remainder Beneficiaries have Standing to Challenge Trustee Action

Rachins v. Minassian, 251 So. 3d 919 (Fla. Dist. Ct. App. July 11, 2018)

1. *Factual Background*

Zaven Minassian ("Decedent") died in 2010, survived by a spouse ("Paula") and two adult children from a prior relationship ("the children"). Prior to his death, Decedent executed a restatement of a revocable trust created in 2008, for which Decedent and Paula served as Trustees. In that restatement of revocable trust (the "Trust"), Decedent left all his property not subject to federal estate tax to a Family Trust. During Paula's lifetime, the Trust was to distribute income and principal to Paula in her discretion as Trustee, for her "health, education, and maintenance." Upon Paula's death, any remaining funds would be distributed to separate trust shares for the children.

Shortly after Decedent's death, the children filed a complaint challenging Paula's administration of the Family Trust. Paula moved to dismiss based on lack of standing, arguing that the children were not beneficiaries of the Family Trust. The trial court denied this motion.

Paula appointed a Trust Protector pursuant to the Trust terms, who amended the Trust to clarify that, if there was any property remaining upon Paula's death, the remaining property would be disbursed to a new Trust for the benefit of the children. The children challenged the validity of this amendment, and the trial court entered partial summary judgment for the children on that issue. Paula appealed and the Court of Appeals held that the amendment was valid. In that opinion, the Court noted the trust protector's affidavit stating "the husband settled on the multiple-trust scheme for the very purpose of preventing the children from challenging the manner in which the wife spent the money in the Family Trust during her lifetime."

On remand from that decision, the children filed an amended complaint alleging, among other things, that Paula had dissipated Trust assets due to a gambling problem, and adding the drafting law firm as an additional defendant (collectively, with Paula, "the Defendants"). The Defendants moved for summary judgment due to lack of standing as the children were "neither

beneficiaries nor qualified beneficiaries as those terms are defined in the Trust Code." The trial court concluded the children lacked standing and an appeal followed.

2. *Analysis*

The Court focused its ruling on the following definitions of "beneficiary" and "qualified beneficiary." A beneficiary is "a person who has a present or future beneficial interest in a trust, vested or contingent…" FSA § 736.0103(4). A qualified beneficiary "encompasses only a limited subsets of all trust beneficiaries. In effect the class is limited to living persons who are current beneficiaries, intermediate beneficiaries, and first line remainder beneficiaries, whether vested or contingent." John G. Grimsley, *Florida Law of Trusts*, 18 Fla. Prac. § 16:1 (2016-2017 ed.).

Looking to Florida law related to obligations, the Court found that "a trustee is always subject to accountability to remaindermen where discretion is improperly, arbitrarily or capriciously exercised." *Mesler v. Holly*, 318 So.2d 530 (Fla. 2d DCA 1975). Moreover, the Court found that Paula's unlimited power to invade trust principal and income is nevertheless subject to implied limitations to protect beneficiaries with an interest in any possible remaining assets upon the primary beneficiary's death. The Court specifically held that this accountability and standing to challenge Trustee decisions based on an equitable interest is not abrogated simply because the interest will flow into a new Trust created for the children, rather than outright. *See Brown-Thill v. Brown*, 929 F.Supp.2d 887 (W.D. Mo. 2013) (finding that grandchildren were qualified beneficiaries even when not currently entitled to trust income or principal because of eventual flow into their father's trust, and from there, to them).

L. Trustee Cannot Force "Involuntary Plaintiff" to Join Suit, and May Not Sue on Behalf of Trust Without Consent of Majority of Trustees

Doermer v. Oxford Financial Group, 884 F.3d 643 (7th Cir. March 7, 2018)

1. *Factual Background*

Richard T. and Mary Louise Doermer formed a multi-million dollar Trust for the benefit of their children, Richard and Kathryn, and each child's descendants. The trust has three Trustees: Richard, Kathryn and a corporate Trustee. Richard and Kathryn fell into "irreconcilable" disputes about management of the Trust after their parents' deaths, including previous litigation. *See Doermer v. Callen*, 847 F.3d 522 (7th Cir. 2017).

In an effort to solve the dispute between the siblings, they agreed to divide the Trust in two, creating one Trust for Kathryn and one Trust for Richard. As part of this proposal, the siblings agreed to move the Trust situs to South Dakota from Indiana. The siblings then spent several months debating the details of the asset allocation between the two new Trusts, before Richard eventually petitioned a South Dakota court to split the Trust. The Court denied this request and the Trust remains intact.

Richard brought this case based on "great losses from disbursements and benefits that he and his family lineage would have been entitled to receive" had the Trust been split according to his preferences. Richard alleges that the reason Kathryn refused this split is due to negligent advice from Oxford Financial Group, who was serving as her financial advisor. Richard therefore sued Oxford in Illinois court based on (1) "breach of financial duty and negligence" and (2) "gross

negligence and wilful [*sic*] and wanton misconduct." The complaint identifies Richard as plaintiff as both a beneficiary and Co-Trustee, and Kathryn as an "involuntary plaintiff."

Applying Illinois choice of law, the Court decided that South Dakota substantive law governed the case, and granted Oxford's motion to dismiss on the grounds that Richard did not have standing to sue Oxford as a Trust beneficiary, or as a Co-Trustee because both state law and the Trust agreement required a majority of Trustees to consent to the suit. Richard appeals.

2. *Analysis*

The Court addressed the appeal on three counts: (a) inclusion of Kathryn as an "involuntary plaintiff," (b) Trust beneficiary standing to sue a third party on behalf of the Trust, and (c) ability of a Co-Trustee to sue on behalf of a Trust without the consent of a majority of Trustees.

a. <u>No Such Thing as Involuntary Plaintiff</u>. The Court found that no provision of the Federal Rules of Civil Procedure, Illinois law or South Dakota law that allows a plaintiff to unilaterally and involuntarily force another party to join their suit as a plaintiff. The Court noted that a party with identical interests could be added as a defendant and then realigned, but that this is not the process that was used in this case. The Court specifically distinguished an involuntary plaintiff procedure used in *Independent Wireless Telephone Co. v. Radio Corp. of America*, as this procedure was abrogated by the 1966 amendments to the Federal Rules of Civil Procedure. 269 U.S. 459 (1926).

b. <u>Trust Beneficiary Has No Standing to Sue Third-Party</u>. As a general rule, a Trust beneficiary lacks standing to sue a third party on behalf of a Trust. Restatement (Third) of Trusts § 107 (2012). The Court noted that the state law applicable in this case only provides an exception where the Trustee's refusal to pursue the claim is improper, and Richard had not alleged any improper behavior by the other Trustees in failing to join his suit.

c. <u>Co-Trustee May Not Sue Without Majority Consent</u>. The Court examined the plaintiff's capacity to sue under state law. Federal Rule of Civil Procedure 17(b)(3). The Court found that Illinois law bars a Trustee from suit against a third-party in their capacity as Trustee without the consent of at least one of the Co-Trustees. The Court noted that this is consistent with South Dakota law, and also codified in the Trust agreement itself.

M. A Grantor's Unilateral Right of Substitution of Assets Can be Unencumbered by a Fiduciary Duty to Determine the Equivalent Value of Substituted Assets
Manatt v. Manatt, 2018 WL 3154461 (S.D. Iowa May 2, 2018)

Bradford Manatt ("Brad") established an intentionally defective grantor trust ("IDGT") entitled the BJM 2012 Trust for the Benefit of Erik M. Manatt ("BJM Trust"). Erik M. Manatt ("Erik") was Brad's cousin and also served as Trustee of the BJM Trust. At the time the BJM Trust was created, Brad was the president of Manaco Corporation. Brad devised 53.57 shares of Manaco stock to the BJM Trust; 5.36 shares were gifted and 48.21shares were sold via a promissory note. Payments were to be made from the dividends of Manaco stock held in the BJM Trust. Several years later, acting under the grantor's substitution power under the BJM Trust, Brad substituted 53.57 shares of Manaco stock at a rate of $83,000 per share. Erik, as Trustee, notified Brad that he rejected the substitution because it did not constitute equivalent value. Erik

subsequently notified Brad that he was paying off the promissory note. Brad then filed for a declaratory judgment against Erik, seeking a judgment ordering that Erik sign and deliver the 53.57 shares of stock, accept the substitution and execute and deliver all documents necessary to effectuate the exchange of assets. Brad also asked the Court to determine the rightful owner of the stock held in the BJM Trust. Erik argued that because the BJM Trust was structured as an IDGT, it has to comply with certain terms, and as Trustee, Erik had the fiduciary duty to ensure compliance with the substitution power. Erik also asserted that he had the fiduciary duty to ensure the substituted assets were of equivalent value, and here, Brad had previously valued the Manaco stock held by his children at $113,000 per share versus the $83,000 per share that Brad had proposed to carry out the substitution. It should be noted, as the Court stated, that the parties to this litigation did not dispute that the substitution power in the trust instrument gives Brad the power to substitute assets, nor do they contest that Erik, as Trustee, has to duty to ensure the substitute assets are of equivalent value. The dispute revolves around whether Erik's duty to determine equivalent value could prevent Brad from substituting trust assets.

The Court held that the plain language of the BJM Trust allows Brad to substitute assets of equivalent value without requiring the consent of the Trustee or anyone else. The Court relied on prior case law and prior court reasoning that supported the idea that while a Trustee must ensure equivalent value of the substitute assets, the Trustee does not have the power to prevent such an exchange. *See, Benson v. Rosenthal*, 2016 WL 2855456 (May 16, 2016). The Court found that Brad could not be prevented from exercising his unilateral power to substitute assets, and that he has the unilateral power to substitute assets. Moreover, the Court found it notable that Brad's chosen trust vehicle, a IDGT (which allows a grantor to control the corpus of the trust) confirms the intent of the grantor was to have control of the trust assets and retain control of the assets.

N. Personal Representative Granted Access to Decedent's Digital Assets

In re Scandalios, 2019 WL 266570 (N.Y.Sur. January 14, 2019)

In 2017, Ric Swezey (the "Decedent") died unexpectedly, survived by his spouse and children. Decedent's Will left all personal property (with some exceptions that are not related to the case at hand) and the residue of the estate to his Personal Representative, Nicholas Scandalios (the "Personal Representative"). Personal Representative particularly wanted to access the digital photos that were stored on Decedent's Apple accounts, which included family photos and Decedent's artistic photography. Decedent and Personal Representative shared their home office, so Personal Representative knew that Decedent used the Apple account to store photos. Personal Representative claimed that the intention was to transfer Decedent's pictures to Personal Representative's account.

Personal Representative sought to access the photos from Apple directly, but Apple required a court order authorizing that access to disclose any information associated with Decedent's Apple account. Decedent's Will did not include any specific provision for digital assets, and Decedent also did not use an online system that would grant Personal Representative access to his digital assets.

The Court agreed with the Personal Representative, and issued a court order that required Apple to allow Personal Representative to access Decedent's photographs stored on the Apple account. The Court primarily relied on various New York probate and estate statutes that have

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subsumed digital property into traditional definitions of property. For example, the Court looked at Article 13 of the Estates, Powers and Trusts Law, which has granted fiduciaries the same power over digital assets of a decedent as over traditional probate assets.

The Court distinguished a request for access to Decedent's photographs from a request for access to Decedent's electronic communications. Access to Decedent's communications would require proof of Decedent's consent or a court order. Personal Representative sought only digital property, which the Court held did not require a court order, but the Court issued an order to satisfy Apple's requirement.

O. Beneficiary's Petition Asserting Breach of Trust and Removal of a Trustee Violated the Trust's No-Contest Clause and Caused the Beneficiary's Interest in the Trust to be Canceled

Knopik v. Shelby Investments, LLC, 2019 WL 2093887 (Mo. App. W.D. May 14, 2019)

Samuel Knopik ("Knopik") was the sole beneficiary of the Knopik Irrevocable Trust, of which Shelby Investments, LLC ("Shelby") was the Trustee. Pursuant to the trust agreement, from December 2016 to December 2020, Knopik was to receive $100.00 each month from the trust estate. On January 4, 2021, Shelby was to distribute the remaining trust estate to the settlor and terminate the trust. In 2017, Knopik received his monthly distributions for January and February, however, Shelby stopped making monthly distributions from the trust after February and affirmatively stated that it did not intend to make any future payments to Knopik. Thereafter, Knopik filed an action against Shelby for breach of trust and removal of the Trustee. Shelby then filed a counterclaim and request for declaratory judgment asserting that Knopik's petition violated the trust's no-contest clause. The trust's no-contest clause stated that, if a beneficiary contests the validity of the trust, makes a claim against a trustee for maladministration or breach of trust, or attempts to remove a Trustee for any reason, all provisions in favor of the beneficiary would be canceled and the entire trust estate would revert back to the settlor. The Circuit Court granted Shelby's motion for summary judgment and the Court of Appeals affirmed, finding that Knopik's Petition violated the no-contest clause.

The Court of Appeals noted that while forfeitures are not favored by the law, the Court must enforce a no-contest provision where there is clear intent on the part of the trustor that such conduct shall cause forfeiture of a beneficiary's interest. The Court further noted, *citing Commerce Trust Co. v. Weed*, 318 S.W.2d 289 (Mo. 1958), that, in such instances, such no-contest provisions would be enforced without regard to any good faith or probable cause on the moving party, because "a person may dispose of his property as he wishes." In making its ruling, the Court found that the trust contained clear and unambiguous language of his intention regarding a filing of a petition asserting breach of trust and removal causing forfeiture of a beneficiary's interest in the trust.

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V. RETIREMENT ASSETS

A. Surviving Ex-Spouse Receives But Not Entitled to Retain IRC § 401(k) Account

Hebert v. Cunningham, No. 1-17-2135, 2018 IL App (1st) (December 28, 2018)

The decedent (Kevin) and Betty were married in 1981. Kevin participated in his employer's 401(k) plan. In November of 1998, Kevin, using a proper beneficiary designation form, named Betty as primary beneficiary of his account. In November of 2003, Kevin and Betty's marriage was dissolved by the Circuit Court of Cook County, Illinois. Paragraph 5 of the divorce decree provided that "each party shall retain sole ownership of their separate retirement assets, free and clear from any claim of the other party, as follows:…[Kevin] shall retain sole ownership of his…401(k) account…"

The divorce decree contained the following additional language:

> Except as otherwise provided herein, each of the parties hereto does hereby forever relinquish, release, waive, and quitclaim to the other party hereto all property rights and claims which he or she now has or may hereafter have, as husband, wife, widow, widower or otherwise, or by reason of the marital relations now existing between the parties hereto or by virtue of any present or future law of any state or of the United States of America or any other country, in or to or against the property of the other party or his or her estate, whether now owned or hereafter acquired by such other party. Each of the parties hereto further covenants and agrees for himself and herself and his or her heirs, executors, administrators and assigns, that he or she will never at any time hereafter sue the other party or his or her heirs, executors, administrators and assigns, for the purpose of enforcing any of the rights relinquished under this paragraph.

Kevin died in March of 2014. He had not changed his designation of Betty as primary beneficiary of his 401(k) account.

Kevin's executor, appointed by the Probate Division of the Circuit Court of Cook County in July, informed the 401(k) plan custodian in August that Kevin's account proceeds should be paid over to Kevin's estate. The plan administrator and the trustee concurred. On October 16, Betty filed, in the Circuit Court of Cook County, a complaint for declaratory judgment asserting she was the rightful beneficiary of Kevin's account. The plan administrator removed the case to federal district court. The District Court entered an order to the effect that Betty was the rightful beneficiary under ERISA, but the District Court specifically declined to address the executor's claim for relief under Illinois law. *Cunningham v. Hebert*, No. 9292, 2016 WL 6442180 (N.D. Ill. November 1, 2016). The district court dismissed the executor's claim against Betty that she was in breach of the divorce decree "without prejudice to refiling in the Circuit Court of Cook County."

The executor took the not-so-subtle hint and, on November 15, filed her own complaint for declaratory judgment and other relief in Cook County Circuit Court. On July 25, 2017, the Circuit Court entered its order imposing a constructive trust on the 401(k) funds and requiring Betty to turn over the funds to the executor.

The Illinois Appellate Court affirmed the Cook County Circuit Court. In so doing, it first rejected Betty's claim that the Circuit Court's order was barred by the doctrine of *res judicata* because the order of the District Court was clearly limited to determination of Betty's ERISA-based claim and specifically avoided making any ruling or pronouncement on the Illinois law issue addressed by the Circuit Court.

Next, the Appellate Court distinguished *Kennedy v. Plan Administrator for DuPont Savings & Investment Plan*, 555 U.S. 285 (2009), which Betty claimed was dispositive. In *Kennedy*, the Supreme Court held that the "plan administrator did its statutory ERISA duty by paying the benefits to [decedent's former spouse] in conformity with the plan documents," notwithstanding the divorce decree." However, *Kennedy* expressly did not determine whether a named beneficiary is entitled to retain funds *after* their initial distribution by an ERISA plan administrator. Indeed, in a footnote, the Supreme Court declined to "express any view as to whether the Estate could have brought an action in state or federal court against [decedent's former spouse] to obtain the benefits after they were distributed."

Finally, the Appellate Court disposed of Betty's argument that the divorce decree did not clearly enough reflect an intention on the part of Betty to waiver any interest in Kevin's 401(k) account. In so doing, the Court stated: "We find that th[e] broad waiver language unequivocally encompassed *all* property rights of any nature, including the beneficial property interest in the 401(k) at issue in this case. Indeed, it is hard to imagine how the waiver could have been worded more broadly."

VI. BUSINESS ASSETS

A. The Income Tax Deduction for Qualified Business Income

T.D. 9847 (February 8, 2019); REG-134652-18, 84 Fed. Reg. 3015 (February 8, 2019)

1. *Introduction*

The 2017 Tax Act enacted new Internal Revenue Code ("IRC") § 199A, which, in general, creates a deduction for the combined qualified business income received from certain pass-through and disregarded entities. This Section does not apply to taxable years beginning after 2025. IRC § 199A(i).

On August 8, 2018, the IRS issued proposed regulations under IRC § 199A. REG-107892-18, 83 Fed. Reg. 40884 (August 16, 2018). These regulations were finalized on January 18, 2019 and became effective after corrections on February 8, 2019. T.D. 9847. With the final regulations, the IRS issued new proposed regulations to provide guidance regarding previously suspended losses, regulated investment companies, charitable remainder trusts and split-interest trusts. REG-134652-18, 84 Fed. Reg. 3015 (February 8, 2019) (the "Newly Proposed Regulations").

For individuals, the deduction is available whether the individual claims the standard deduction or itemizes deductions. IRC § 63(b); Joint Explanatory Statement of the Committee of Conference on H.R. 1, 115th Cong. 1st Sess, p. 39 (2017). The deduction does not affect the calculation of adjusted gross income. IRC § 62(a); Akers, "Section 199A – Qualified Business

Income Deduction Including Highlights of Final and Newly Proposed Regulations," at http://www.bessemer.com (February 2019).

The deduction is available for individuals, partnerships, S corporations, estates, trusts and any other taxpayer other than a C corporation. IRC § 199A(a). The deduction is applied at the pass-through owner level. IRC § 199A(f)(1); Treas. Reg. § 1.199A-1(e)(1); -6. The deduction does not affect the adjusted basis of a partner's interest in a partnership, the adjusted basis of a shareholder's stock in an S corporation or an S Corporation's accumulated adjustments account. Treas. Reg. § 1.199A-1(e)(1). The deduction is available for up to 20% of the taxpayer's taxable income (without consideration of IRC § 199A) minus the taxpayer's net capital gains (IRC § 1(h)). Net capital gain is defined as net capital gain under IRC § 1221(11) and includes qualified dividend income. Treas. Reg. § 1.199A(b)(3). The deduction cannot exceed the combined qualified business income of the taxpayer. IRC § 199A(a), (e)(1).

The deduction is for income tax purposes only. It is not available to reduce self-employment tax under IRC § 1402 or net investment income tax under IRC § 1411. IRC § 199A(f)(3); Treas. Reg. § 1.199A-1(e)(3).

2. *Qualified Business Income*

In general, qualified business income ("QBI") means the "deductible amount," determined under IRC § 199A(b)(2), for each qualified trade or business carried on by the taxpayer, plus 20% of qualified REIT dividends and qualified publicly traded partnership ("PTP") income. IRC § 199A(b)(1), (c); Treas. Reg. § 1.199A-1(b)(5), -3(b).

The deductible amount is the lesser of: (a) 20% of the taxpayer's QBI with respect to the qualified trade or business (defined below); or (b) the greater of 50% of the W-2 wages with respect to the qualified trade or business, or the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property ("UBIA") ((b) is hereinafter referred to as the "Wage/UBIA Test"). IRC § 199A(b)(2); Treas. Reg. § 1.199A-1(d)(2)(iv). The Wage/UBIA Test is applied only if taxable income exceeds the threshold amount, discussed below. IRC § 199A(b)(3)(A); Treas. Reg. § 1.199A-1(c).

Generally, QBI consists of net income from an active trade or business within the United States, less qualified REIT dividends or qualified PTP income. It does not include, among other items, capital gains, dividends, non-business interest, wage income received as an employee, any guaranteed payment described in IRC § 707(c) or payments to a partner for acting in a capacity other than a partner under IRC § 707(a). IRC § 199A(c); Treas. Reg. § 1.199A-3(b).

3. *Qualified Trade or Business; Specified Service Trade or Business; Trade or Business of Being an Employee*

A qualified trade or business is a trade or business other than: (a) a specified service trade or business ("SSTB"); or (b) the trade or business of being an employee. IRC § 199A(d)(1).

In general, a "trade or business" is defined in accordance with the provisions of IRC § 162(a). Treas. Reg. § 1.199A-1(b)(14). The IRS issued a proposed revenue procedure, Notice 2019-07, 2019-09 I.R.B. 740 (January 18, 2019), to provide a safe harbor permitting a rental real

estate enterprise to be treated as a trade or business. A trade or business conducted by a disregarded entity will be treated as conducted by the owner of that entity. Treas. Reg. § 1.199A-1(e)(2).

The exclusion for a SSTB applies only if the taxpayer's taxable income is above the threshold amount, discussed below. These trades or businesses include those in the fields of law, health, accounting, financial services, actuarial science, performing arts, consulting, athletics, brokerage services, investment management or any business where the principal asset is the reputation or skill of one or more of its employees. Notwithstanding this provision, trades or businesses in the fields of engineering and architecture are considered qualified trades or businesses. Treas. Reg. § 1.199A-5(b).

If the trade or business is a SSTB and taxable income exceeds the phase-in range above the threshold amount, discussed below, none of the QBI, wages or UBIA for purposes of the Wage/UBIA Test will be taken into account in determining the taxpayer's QBI, even if the item is derived from an activity that is not itself a SSTB. IRC § 199A(d)(2); Treas. Reg. § 1.199A-5(a).

The regulations provide that a trade or business is not considered a SSTB if it has gross receipts of $25 million or less per taxable year and less than 10% of such gross receipts is attributable to the performance of services in a SSTB. If gross receipts are greater than $25 million in a taxable year, the trade or business still would not be a SSTB if less than 5% of the gross receipts are attributable to the performance of services of a SSTB. Treas. Reg. § 1.199A-5(c)(1).

The regulations contain anti-abuse rules related to SSTBs. A trade or business, or the portion of a trade or business, that provides property or services to a SSTB also is considered a SSTB if there is 50% or more common ownership with the SSTB receiving such property or services. These rules are intended to prevent the division of a SSTB into a SSTB and a non-SSTB for the purpose of increasing the IRC § 199A deduction. Treas. Reg. § 1.199A-5(c)(2).

4. *Taxpayer With Taxable Income Above Threshold Amount*

The threshold amount for 2019 is $160,700 of taxable income, or $321,400 of taxable income for a taxpayer filing a joint return. Rev. Proc. 2018-57, 2018-49 I.R.B. 827 (December 3, 2018). This threshold is indexed for inflation. IRC § 199A(e)(2).

If a taxpayer's taxable income is above the threshold amount, and the Wage/UBIA Test results in an amount that is less than 20% of the QBI, then the deductible amount determined under IRC § 199A(b)(2), discussed above, is reduced by a formula based on the taxable income in excess of the threshold amount. For 2019, if taxable income exceeds $210,700 ($421,400 for a taxpayer filing a joint return) the deduction under IRC § 199A is unavailable. IRC § 199A(b)(3); Treas. Reg. § 1.199A-1(d)(2)(iv).

There is a second limitation based on the threshold amount that applies to a SSTB, defined above. If taxable income exceeds the threshold amount, only a certain percentage of items of income, gain, deduction or loss, and the W-2 wages and UBIA shall be used in determining the deductible amount, defined above. The percentage is determined by a formula that reduces the percentage based on the amount by which taxable income exceeds the threshold amount. Once taxable income exceeds the threshold amount by $50,000 ($100,000 for taxpayer filing a joint return), the deduction is unavailable for the taxpayer's interest in the SSTB. IRC § 199A(d)(3).

The taxpayer's interest in a SSTB may be subject to both the phase-out under IRC § 199A(b)(3) and (d)(3). Treas. Reg. § 1.199A-1(d)(4)(vi), Ex. 6.

For wages to be taken into account, the wages must be properly allocable to QBI of one or more trades or businesses. IRC § 199A(b)(4); Treas. Reg. § 1.199A-2(b). The IRS has issued a revenue procedure, Rev. Proc. 2019-11, 2019-09 I.R.B. 742 (January 18, 2019), which provides three methods for calculating W-2 wages.

5. *Aggregation*

The regulations provide rules allowing a taxpayer with interests in related trades or businesses to combine their QBI, W-2 wages and UBIA for purposes of applying the Wages/UBIA Test. Aggregation is permitted, but not required. In general, the regulations provide that aggregation is permitted if the trades or businesses are under common control, integrated and provide similar products or services. The regulations provide family attribution rules for determining control. Aggregation is disallowed for SSTBs except as provided above pursuant to Treas. Reg. § 1.199A-5. Treas. Reg. § 1.199A-4.

6. *Multiple Owners or Beneficiaries*

For entities with multiple owners, each owner is allocated the owner's allocable share of income, losses, basis and other items necessary to calculate the owner's QBI deduction. IRC § 199A(f)(1); Treas. Reg. § 1.199A-6. With respect to a non-grantor trust or estate with multiple beneficiaries, each beneficiary's portion of the trust or estate's QBI, W-2 wages and UBIA is based on the proportion of such beneficiary's portion of distributable net income ("DNI"), with any undistributed DNI used to determine the trust or estate's QBI, W-2 wages and UBIA. Whether a trust or estate exceeds the threshold amount is determined after considering any distribution deduction. Treas. Reg. § 1.199A-6(d).

The regulations also provide that a trust formed with a principal purpose of avoiding, or of using more than one, threshold amount under IRC § 199A will not be respected as a separate trust entity for purposes of determining the threshold amount. Treas. Reg. § 1.199A-6(d)(3)(vii).

The Newly Proposed Regulations provide that separate shares of a trust would be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount. Prop. Reg. § 1.199A-6(d)(3)(iii).

7. *Regulations Under IRC § 643(f)*

IRC § 643(f) provides that, for purposes of subchapter J of the Internal Revenue Code (IRC §§ 641-692), pursuant to regulations, two or more trusts shall be treated as one trust if: (a) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries; and (b) a principal purpose of such trust is the avoidance of the income tax. For purposes of IRC § 643(f), spouses shall be treated as one person.

The regulations include provisions that implement the rule under IRC § 643(f) by preventing taxpayers from dividing trust assets among multiple trusts so that each trust has income below the threshold amount. Treas. Reg. § 1.643(f)-1.

8. *Effective Date of the Final and Newly Proposed Regulations*

Most of the regulations apply to taxable years ending after February 8, 2019. *See, e.g.*, Treas. Reg. § 1.199A-1(f)(1). The anti-abuse provisions of the regulations, however, apply retroactively to taxable years ending after December 22, 2017, the date of enactment of the 2017 Tax Act (Pub. L. No. 115-97). *See, e.g.*, Treas. Reg. § 1.199A-5(e)(1). The regulations under IRC § 643(f) apply to taxable years ending after August 16, 2018, the date of publication of the Proposed Regulations in the Federal Register. Treas. Reg. § 1.643(f)-1(b). The Newly Proposed Regulations would apply to taxable years ending after the date the final regulations are published in the Federal Register, but taxpayers may rely on the Newly Proposed Regulations before that date.

B. Court Values Family–Owned S-Corporation Stock to Determine Refund of Gift Tax Overpayment

Kress v. United States, 372 F. Supp. 3d 731 (E.D. Wisc. March 26, 2019)

Taxpayers were shareholders in GBP, a family-owned subchapter S-corporation. The Kress family owned approximately 90% of GBP's shares of common stock, and GBP's employees and directors owned the remaining 10%. There was an established price of 120% of book value for the sale and purchase of GBP shares by employees and directors, but there was no price established for shares transferred to members of the Kress family. Certain restrictions limited the ability to sell family and non-family shares of GBP stock.

Taxpayers gifted minority shares of GBP stock to their children and grandchildren in 2006, 2007 and 2008 and filed gift tax returns for those years reporting the fair market value of the gifted shares as $28.00 per share for 2007, $25.90 per share for 2008, and $21.60 per share for 2009. The IRS challenged the amounts reported on the gift tax returns, finding that the fair market value of the stock was the price used for actual share transactions between GBP and its employees, which was $45.97 per share for 2007, $47.63 per share for 2008 and $50.85 per share for 2009. Taxpayers paid the gift tax deficiencies and filed amended gift tax returns seeking refunds for the additional taxes and interest they paid.

The sole issue in this case is the fair market value of the GBP stock taxpayers gifted to their children and grandchildren in 2007, 2008 and 2009. The government abandoned its initial valuation assessments and requested that the court adopt its expert's conclusions of fair market value of $38.40 per share for 2007, $27.81 per share for 2008 and $40.05 per share for 2009.

> The court determined that the government expert overvalued the shares because he failed to consider appropriate comparable companies under the market approach and the impact of the economic recession, improperly treated non-operating assets and applied a low lack-of-marketability discount. The government's expert also applied a "subchapter S premium" to his valuation to account for the tax advantages associated with subchapter S status, but the court determined that GBP's subchapter S status was a neutral consideration with respect to the valuation of its stock.

The Taxpayers utilized two valuation experts, and the court determined that one of the expert's valuations was reliable. The expert's valuation of the stock was $28.00 per share for

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2007, $25.90 per share for 2008 and $21.60 per share for 2009. Modifying the fair market value of the shares, as calculated by taxpayer's expert, by a 3% downward adjustment to discounts for lack of marketability was warranted because the family transfer restriction contained in the bylaws could not be considered in calculating lack of marketability discount because unrelated parties dealing at arms' length would not agree to such arrangement. Accordingly, the court concluded the fair market value of the stock to be $29.20 per share for 2007, $27.01 per share for 2008 and $22.50 per share for 2009.

C. Related Entities Entered Into Bona Fide Loans Despite Defects in Documentation But Found Liable for Constructive Distributions on Bargain Sales

Dynamo Holdings Limited Partnership v. Commissioner, T.C. Memo. 2018-61 (May 7, 2018)

1. *Facts*

Dynamo Holdings LP ("Dynamo") and Beekman Vista, Inc. ("Beekman") were real estate management and development entities. Beekman was owned by a Canadian entity. Beekman and Dynamo had shared ownership; generally, these businesses were managed by the same people, who were members of the same family. In addition, the members of the family, or trusts established by members of the family, held ultimate control over both Beekman and Dynamo.

During the relevant time period of this case (2005-2007), Dynamo was a newly-established entity. The owners of both entities desired to use Beekman's assets to help start Dynamo's operations. Beekman made advances, classified as loans, to Dynamo to fund Dynamo's operating expenses and to purchase assets. The loans were not accompanied by contemporaneous promissory notes (although the parties subsequently executed promissory notes to document prior advances during the tax years at issue). In addition, Dynamo provided no collateral, the loans had no maturity date and Beekman provided no invoices for payments due nor did it ever demand payment. Due to the various ownership structures and beneficial interests, these loans had the ultimate effect of decreasing the beneficial interests of the family's senior generation and increasing the beneficial interests of the junior generation.

The IRS argued that these advances were gifts, and not loans, and the owners of Dynamo should be treated as receiving gifts from the owners of Beekman. Since Beekman was owned by a Canadian entity, the IRS argued that withholding taxes should apply to these deemed gifts.

Beekman also sold real estate interests to Dynamo. Beekman did not obtain third party appraisals. The parties relied on their own expertise in valuing the properties. To document each transaction, Beekman simply increased Dynamo's debt obligation. The value of the assets sold exceeded the increase in Dynamo's debt obligation by approximately $200 million in the aggregate. The IRS again argued that these sales were actually deemed gifts/constructive distributions that were subject to withholding taxes.

2. *Tax Court's Analysis*

a. **Loan Transactions**. The Tax Court explained that the parties must have intended to enter into a debtor-creditor relationship for the transaction to be a loan. Generally,

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the parties had to show an unconditional obligation on the part of Dynamo to repay and an unconditional intention on the part of Beekman to secure repayment. The Tax Court stated that "[w]e apply special scrutiny to intrafamily transfers and transactions between entities in the same corporate family or with shared ownership," and apply a presumption that transfers between family members are gifts.

The Tax Court applied a nine-factor analysis to determine whether a debt was actually a gift:

> (a) There was a promissory note or other evidence of indebtedness, (b) interest was charged, (c) there was security or collateral, (d) there was a fixed maturity date, (e) a demand for repayment was made, (f) any actual repayment was made, (g) the transferee had the ability to repay, (h) any records maintained by the transferor and/or the transferee reflected the transaction as a loan, and (i) the manner in which the transaction was reported for Federal tax is consistent with a loan.

Jones v. Commissioner, T.C. Memo. 1997-400, *aff'd without published opinion*, 177 F.3d 983 (11th Cir. 1999).

The Tax Court found that the advances were loans, despite the defects in documentation. The parties treated the advances as loans in their general ledgers (each entity kept their own ledgers) and interest accrued on the outstanding balance. The Tax Court pointed out that Beekman's general ledger software did not allow them to correct mistakes by just deleting them. Employees of Beekman had to make offsetting entries elsewhere in the ledger. The Tax Court believed that these corrections gave credibility to their reporting.

The parties later executed a promissory note in 2008 for the loans made from 2005 to 2007. The Tax Court pointed out that the promissory notes, when executed, were demand notes, so the lack of a maturity date was not a concern. The Tax Court believed that the promissory notes between entities with common ownership are not always necessary. Beekman and Dynamo had the same management team with full knowledge of each company. Thus, it was not necessary for a party send him or herself an invoice, run a credit check on themselves or require an audited financial statement. There was already full disclosure of the debtor's business.

The parties consistently reported the transactions as loans for tax purposes. In addition, the loans were repaid, without demand, as intended and the general ledgers were updated accordingly. The accrued interest was also repaid. The Tax Court accepted Dynamo's repayments regardless of the manner of repayment. In addition to paying cash to Beekman, Dynamo repaid Beekman by providing management services and providing payments on debts that Beekman owed to third parties.

The Tax Court concluded that Dynamo was adequately capitalized. Expert testimony provided that Dynamo was financially secure enough to enable it to obtain loans from third-party lenders on substantially the same terms as the loans from Beekman.

Therefore, Beekman was not required to withhold taxes regarding these loans. In addition, Dynamo was allowed to deduct its interest payments.

b. **Sale Transactions**. Regarding the sales of assets to Dynamo, the Tax Court stated that the valuation experts provided sufficient evidence that the sales were bargain sales that increased the value of Dynamo. The Tax Court concluded that these bargain sales resulted in constructive distributions to the common interest holders. The transfers were under the control of the common owners. In addition, the transfers were carried out for the common owners' personal benefit and the common owners did in fact benefit. The Tax Court stated that there was no valid business purpose for the sales between the two entities; these transfers could have occurred between Beekman and its subsidiaries. Beekman was therefore required to withhold taxes. The partners of Dynamo were deemed to receive distributions as a result of these sales.

VII. CHARITABLE GIVING

A. Estate Tax Charitable Deduction Reduced when Trustee Diverts Property from Charity and Alters Testamentary Plan

Estate of Victoria E. Dieringer v. Commissioner, 917 F.3d 1135 (9th Cir. March 12, 2019)

1. *Factual Background*

Victoria E. Dieringer ("Decedent") died testate on April 14, 2009, a resident of Oregon. Decedent, a widow, had 12 children. Decedent's trust generally provided for distribution of certain personal effects to her children, specific gifts totaling $600,000 to unrelated charities and the balance of her trust was to be distributed to the Bob and Evelyn Dieringer Family Foundation (the "Foundation"). Her son, Eugene Dieringer ("Eugene") was executor of her estate, Trustee of her trust and the director of the Foundation.

The bulk of Decedent's assets consisted of a majority interest in Dieringer Properties, Inc. ("DPI"), a closely-held business that managed commercial and residential real estate. Decedent owned 425 of 525 voting shares and 7,736.5 of 9,220.5 nonvoting shares of DPI at the time of her death. Prior to her death, Decedent had preliminary discussions with DPI regarding purchase of her interest in the company. In anticipation of a purchase agreement, DPI paid Decedent's trust $45,000, however, no specific redemption agreement was entered before her death.

The estate hired an appraiser to value the DPI stock on a majority basis. The appraiser determined that the voting shares had a value of $1,824 per share and the non-voting shares had a value of $1,733 per share. The non-voting shares received a 5% discount due to the non-voting status. The adjusted value of DPI on Decedent's date of death was $17,777,626.

The United States Estate Tax Return ("Form 706") stated that Decedent owned an interest in DPI with a fair market value of $14,182,471. The estate also claimed an estate tax charitable deduction on the Form 706 of $18,812,181. The estate reported no estate tax liability.

In November 2009, DPI elected S corporation status on the advice of Thomas Keepes, who was a director of DPI. DPI became concerned that the Foundation would be required to make annual distributions of income and could be subject to a tax on the value of its excess business holdings under IRC § 4943. DPI decided to redeem the trust's interests in the company. Prior to redemption, the two voting shareholders were the trust and Eugene, and the non-voting shareholders were the trust, Eugene and Patrick Dieringer (Decedent's son). DPI agreed to redeem

the trust's interest in DPI in exchange for two notes receivable, a short-term note in the amount of $2,250,000 and a long-term note in the amount of $3,776,558. The redemption price was $779 per voting share and $742 per non-voting share.

Eugene arranged for an appraisal of the DPI shares on a minority interest basis, and the appraiser determined that the per-share price was $916 per voting share and $870 per non-voting share. In April 2010, the redemption agreement was modified so that DPI redeemed all of the trust's voting shares and 5,600.5 of the trust's non-voting shares. The long-term promissory note was amended to reflect a value of $2,968,462. The appraised values included a 15% lack of control discount and a 35% lack of marketability discount. The non-voting share value also included a 5% lack of voting power discount.

Separately, Eugene, Patrick and Timothy Dieringer (Decedent's son) entered into subscription agreements with DPI to infuse the company with cash to pay the short-term promissory note. After modifying the subscription amounts to reflect the appraised value on a minority basis, Eugene purchased 100 voting shares and 2,190 non-voting shares for $1,997,568. Patrick purchased 65 shares of voting stock and 86 shares of non-voting stock for $134,393. Timothy purchased 25 shares of voting stock and 108 non-voting shares for $99,611. After the redemption and subscription, Eugene owned 70% of the voting stock of DPI and 48.6% of the non-voting stock.

For calendar year 2009, the trust reported a capital loss in the amount of $385,934 from the sale of the voting stock and a capital loss of $4,831,439 for the sale of 5,600.5 shares of non-voting stock.

On January 1, 2011, the Foundation received 2,163 non-voting shares of DPI, a short-term note receivable in the amount of $2,250,000 and a long-term note receivable in the amount of $2,921,312 in satisfaction of its interests in the trust.

In September 2013, the IRS reduced the charitable deduction based upon the value of property actually distributed to the Bob and Evelyn Dieringer Family Foundation (the "Foundation"). The IRS issued a deficiency notice in the amount of $4,124,717 and assessed an IRC § 6662(a) accuracy-related penalty of $824,943.

The estate challenged the deficiency notice and the accuracy-related penalty. The Tax Court upheld both charges. The estate appealed the Tax Court's decision.

2. *Analysis*

First, the estate argued that the Tax Court erred in taking into account post-death events in determining the value of the charitable deduction, rather than using the date of death values, and in not accounting for a decline in value due to economic forces. Second, the estate argued that the Tax Court erred in upholding the accuracy-related penalty. The challenges relate to the estate's argument that the value of the assets in the trust and the corresponding charitable deduction should be based upon the value of the assets as reported on the Form 706. The estate argued that the decrease in value of the DPI shares occurring between Decedent's date of death and the redemption of shares was the result of several post-death events and should not reduce the value of the charitable deduction permitted under IRC § 2055. The IRS argued that the decrease in value "was

primarily due to the specific instruction to value decedent's majority interest as a minority interest with a 50% discount," rather than the post-death events cited by the estate.

The Court upheld the deficiency, finding that the Foundation did not receive the bequeathed shares of DPI nor the value of those shares as part of the redemption. The Court focused on the process of computing deductions, and that deductions are valued separate from the valuation of the gross estate. *See Abrahamson Foundation v. United States*, 674 F.2d 761, 772 (9th Cir. 1981) ("The statute does not ordain equal valuation as between an item in the gross estate and the same item under the charitable deduction."). The Court affirmed the Tax Court holding that the charitable amount that could properly be deducted was the amount actually transferred to the Foundation, rather than the amount reported on Decedent's Form 706, because the executor's actions altered Decedent's estate plan by diverting value that should have been transferred to the Foundation in favor of three of Decedent's children.

In addition to the estate tax deficiency, the IRS sought an accuracy-related penalty on the basis that the underpayment of estate tax was due to the estate's negligence or disregard of the rules and regulations. The Court found no error in the Tax Court's determination that the IRS met its burden of proof that the estate's position was negligent due to Eugene's specific instructions to the appraiser to appraise a minority interest without informing the appraiser that the redemption was for a majority interest in DPI.

VIII. ASSET PROTECTION

A. Withdrawn Retirement Account Funds Can Retain Exemption Status When Redeposited into a Qualified Retirement Account Prior to Bankruptcy Filing

In Re Jones, 2019 WL 1749219 (Bkrtcy.S.D.Ill. Apr.15, 2019)

The United States Bankruptcy Court considered whether a Debtor may exempt funds that were withdrawn from an IRA, deposited into a checking account and then redeposited into the IRA. On about April 16, 2018, Debtor withdrew $50,000 from his IRA and deposited $49,000 into his personal checking account. He retained $1,000 to purchase lottery tickets. The Debtor then used the funds in his checking account to purchase additional lottery tickets, intending to win money and pay off his debts to avoid filing for bankruptcy. On June 15, 2018, Debtor redeposited $20,000 of the original funds he withdrew back into his IRA. He incurred a $9,000 tax liability with the Internal Revenue Service ("IRS") and the Illinois Department of Revenue for taxes and penalties associated from the withdrawal of funds from his IRA. On October 22, 2018, the Debtor filed for bankruptcy under Chapter 7 of the Bankruptcy Code and listed his IRA on an attached schedule in the amount of $40,000. The Debtor claimed a $40,000 exemption in the IRA under 735 ILCS § 5/12-1006, which allows the exemption of a retirement plan. The Chapter 7 Trustee objected to the Debtor's exemption of $20,000, arguing that the funds lost their exempt status when the Debtor made the withdrawal from the IRA.

The Court ultimately concluded that the Trustee's objection should be overruled. The Court found it notable that the Debtor had deposited the $20,000 back into his account prior to filing his bankruptcy case, and the account was a qualified retirement account at the time of filing. Thus, this met the requirements for a "qualified retirement plan" exemption under § 5/12-1006. This fact is distinguishable from the various cases cited by the Trustee in support of its objection,

where the funds in those cited cases were not deposited into retirement accounts at the time of the bankruptcy filing. Further, the Court noted that any commingling of funds between a retirement account and a personal checking account was irrelevant to the exemption status of the funds, and that whatever happens to the money during the 60-day period prior to repayment similarly does not impact exemption status.

IX. Valuation

A. Tax Court Approves Tax-Affecting in Valuation of Timber Business

Estate of Jones v. Commissioner, T.C. Memo. 2019-101 (August 19, 2019)

1. *Factual Background*

Aaron Jones established Seneca Sawmill Co. ("SSC") in 1954. SSC was a lumber manufacturer. In 1996, SSC elected to be taxed as an S Corporation. In 1992, Jones formed Seneca Jones Timber Co. ("SJTC"), a limited partnership, to own and manage timberlands. SSC and SJTC were interdependent companies. The entities had the same management teams. SSC was the sole general partner of SJTC. The vast majority of the timber harvested by SJTC was sold to SSC. SSC obtained financing by using SJTC's timber as collateral. Financing utilized by SSC was treated as a loan from SJTC. SSC would pay back SJTC or loan money to SJTC when SSC generated enough revenue to do so. The loans between SSC and SJTC did not require collateral and SSC was charged the same interest charged by its third-party lender.

Jones owned most of the shares in SSC and the limited partner units in SJTC, while Jones's daughters owned small interests in both entities. SSC issued both voting and nonvoting stock. Transfers of interests in either entity were subject to a buy-sell agreement. Proposed transfers to a non-family member were subject to rights of first refusal held by the entity at issue and the other interest holders. The buy-sell agreements required that fair market value be determined after considering cash distributions allocable to the interests and discounts for lack of marketability, lack of control and lack of voting rights.

On May 28, 2009, Jones transferred limited partner units in SJTC as well as voting and nonvoting stock in SSC to several trusts for the benefit of his descendants.

Jones entered into net-net gift agreements with each of his daughters in which his daughters assumed liability for the gift tax and estate tax associated with the transfers. The IRS later conceded that these agreements were permissible.

The IRS issued a notice of deficiency in 2013 challenging the valuation of each of the transfers made in 2009. Jones then died in 2014.

The estate submitted a valuation report for each of the SSC shares transferred and the SJTC units transferred. The estate relied on an income approach, the discounted cashflow ("DCF") method, and a market approach in valuing all the transfers. The estate asserted a value of $380 per limited partner unit in SJTC. Regarding SSC, the estate asserted a value of $390 per share of voting stock and $380 per share of nonvoting stock.

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The IRS submitted a valuation report for the SJTC units transferred. The IRS relied on an asset-based approach, the net asset value ("NAV") method, and a market approach in valuing the SJTC limited partner units transferred. The IRS asserted a value of $2,530 per limited partner unit. The IRS did not submit a valuation report for the SSC shares transferred, but did provide a rebuttal to the estate's valuation report.

2. *Analysis*

The Tax Court first concluded that SJTC should be valued based on the DCF method of valuation rather than the NAV method asserted by the IRS. The estate asserted that since SJTC is an operating company that sells products to consumers, an income-based approach like the DCF method is most appropriate. The IRS asserted that SJTC is an investment company and an asset-based approach like the NAV method should be utilized. The Tax Court stated that SJTC has characteristics of both an operating company and an investment company. However, the NAV method would only be appropriate if it was likely that SJTC would sell its timberlands, as opposed to its timber, and that Tax Court found that there was no indication that SJTC would do so.

The estate's valuation reports for SJTC and SSC tax-affected its earnings by using a 38% tax rate to adjust its net cashflow and the cost of debt capital. The valuation reports then applied a premium to reflect the benefit of the dividend tax avoided by not being a C Corporation. The IRS argued that tax-affecting inappropriately favors the hypothetical buyer over the hypothetical seller in applying the definition of fair market value. The IRS asserted that a zero tax rate better reflects the entities' flowthrough status for income tax purposes.

The Tax Court agreed with the estate's tax-affecting in its valuations. The IRS reviewed three Tax Court cases, all of which rejected the use of tax-affecting. *Gross v. Commissioner*, T.C. Memo. 1999-254; *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, *supplemented by* T.C. Memo. 2011-244; *Estate of Guistina v. Commissioner*, 101 T.C.M. (CCH) 1676. The Tax Court stated that those cases did not reject tax-affecting but rather rejected how tax-affecting was applied in those cases. The Tax Court added, "[t]he question in those cases, as here, was not whether to take into account the tax benefits inuring to a flowthrough entity but how." The Tax Court found that the estate's valuation reports have "more accurately taken into account the tax consequences of [the entities'] flowthrough status."

The Tax Court accepted the estate's treatment of the intercompany loans from SSC to SJTC and SSC's general partner interest in SJTC as operating assets. The estate's treatment of these items properly reflected the fact that SSC and SJTC were "interdependent parts of a single business enterprise" rather than separate business entities.

Finally, the Tax Court concluded that a 35% discount for lack of marketability, asserted by the estate, was reasonable.

X. TAX PROCEDURE

A. Proof of Claim in Probate Proceeding Satisfies IRC § 6502(a)

United States v. Estate of Chicorel, 907 F.3d 897 (6th Cir. October 25, 2018)

1. *Background*

Decedent died in 2006 with an outstanding tax balance of $140,905 for tax year 2002, which was assessed in 2005. Decedent's nephew was appointed the estate's personal representative and published a notice to creditors of the four-month deadline for presenting claims but did not mail the notice to the government despite it being a known creditor of the estate. In 2009, the government filed a proof of claim in the Michigan probate proceeding, but there was no response.

The government commenced this collection proceeding action in 2016, seeking to reduce the tax assessment to judgment. The estate claimed that the statute of limitations bars the government from bringing this collection action. The Eastern District of Michigan held that the government's proof of claim tolled the statute of limitations and granted the government's motion for summary judgment. The estate appealed.

2. *Holding*

IRC § 6502(a) provides that, after the government assesses the tax, "such tax may be collected by levy or by a proceeding in court, but only if the levy is made or the proceeding begun—(1) within 10 years after the assessment of the tax." The government contended that it satisfied IRC § 6502(a) by filing its proof of claim in the probate proceeding. The government argued that the proof of claim was a "proceeding in court" for purposes of IRC § 6502(a). The government also argued that any timely filed proceeding in court satisfies the statute of limitations and additional proceedings can be filed anytime thereafter.

Determining whether the proof of claim was a "proceeding in court" for purposes of IRC § 6502(a) was a question of federal law turning on the nature, function and effect of the proof of claim under state law. The inquiry takes into account: whether the proof of claim serves merely to provide notice to the estate, whether it works to toll statutes of limitations and whether it will necessarily lead to a final disposition of the claim. The court noted that Michigan law permits a proof of claim to toll state statutes of limitation. In addition, a properly presented proof of claim requires action on the part of the estate. By filing the proof of claim, the creditor puts the claim on the path towards final disposition. The court held that the nature, function and effect of a proof of claim in Michigan had significant legal consequences for the creditor, the estate and Michigan law generally. Accordingly, the proof of claim qualified as a "proceeding in court" for purposes of IRC § 6502(a).

In considering whether the timely filed proof of claim satisfied the statute of limitations for the government's action, the court held that the statute of limitations in IRC § 6502(a) was satisfied once the government commenced any timely proceeding in court. It was the act of filing, rather than the receipt of judgment that satisfied the statute of limitations. So long as the liability remained unsettled, a single timely proceeding extended the ability of the government to collect

the assessment by levy or proceeding in court beyond the ten-year limitations period in IRC § 6502(a).

Therefore the United States Court of Appeals for the Sixth Circuit affirmed the district court's decision to grant summary judgment in favor of the government.

B. IRS's Determination to Sustain Proposed Levy Action was Abuse of Discretion

Campbell v. Commissioner, T.C. Memo 2019-4 (February 4, 2019)

1. *Background*

The IRS examined Petitioner's 2001 individual income tax return and issued a statutory notice of deficiency, making an upward adjustment to Petitioner's income from $201,519, as reported, to $13,886,234. In response to the statutory notice of deficiency, Petitioner filed a petition with the Tax Court, which entered a decision determining that, for tax year 2001, Petitioner was liable for a deficiency of $1,135,192 and an accuracy-related penalty of $113,519. The IRS assessed the additional tax and penalty and ultimately issued a final notice of intent to levy and notice of federal tax lien ("NFTL").

Petitioner timely requested a collection due process ("CDP") hearing and requested an installment agreement or offer in compromise ("OIC") as a collection alternative. Petitioner submitted an OIC of $12,603 based on doubt as to collectability. The IRS calculated Petitioner's reasonable collection potential ("RCP") to be $19.5 million and, accordingly, rejected Petitioner's OIC as not in the best interest of the government and sustained the proposed levy. The sole issue before the Tax Court was whether the IRS's determination to sustain the proposed levy action regarding the unpaid tax liability was an abuse of discretion.

2. *Tax Court Decision*

The Tax Court noted that, pursuant to IRS procedures, the IRS will reject a compromise that is less than the RCP, absent a showing of special circumstances. The Tax Court held that the IRS erred in its calculation of Petitioner's RCP due to including dissipated assets, amounts collectible from third parties, and assets beyond the reach of the government. Accordingly, the IRS's determination to sustain the levy action was an abuse of discretion.

Including dissipated assets in the RCP calculation is generally applicable when the taxpayer sells, transfers, encumbers or otherwise disposes of assets in an attempt to avoid payment of the tax liabilities. The IRS's calculation of RCP included, as dissipated assets, funds Petitioner had transferred to a trust. The Tax Court noted that Petitioner transferred assets to a trust before he became aware of a potential audit. Further, even if Petitioner was aware of a potential tax liability, his net worth after making the trust contribution exceeded the 2001 tax liability. The Tax Court also rejected the IRS's argument that Petitioner had invested in a Gulf Opportunity Zone to "waste his wealth in an effort to deprive the Government or to shirk his financial obligation to the public fisc."

As an alternative to including Petitioner's trust as a dissipated asset, the IRS asserted that the trust held assets as Petitioner's transferee, nominee or alter ego. The Tax Court concluded that,

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because the IRS did not present evidence supporting the determination that Petitioner had a property right in the trust under state law, the IRS's determination that the trust was a nominee of petitioner was arbitrary, capricious and without sound basis in fact or law.

The IRS is generally permitted to include assets available to the taxpayer but beyond the reach of the government in its RCP calculation. The IRS attempted to argue that Petitioner maintained sufficient control over the trust and had access to the trust assets, but the Tax Court concluded that Petitioner could not and did not control the Trustee's decisions regarding the trust. Accordingly, the trust assets were not considered assets available to Petitioner but beyond the reach of the government.

C. Estate Beneficiaries Found Liable for Unpaid Estate Taxes 19 Years After Decedent's Death

United States v. Ringling, 123 A.F.T.R.2d 2019-814, 2019 WL 858682, 4:17-CV-04006-KES (S.D. Dist. Ct. February 21, 2019)

The defendants in this case are beneficiaries of the estate of Harold Arshem, who died on December 24, 1999. Arshem's estate was required to file a federal estate tax return, but did not do so until May 5, 2008. No payment was made with the return. The IRS made assessments against the estate on July 14, 2008. On August 18, 2008, the IRS sent a notice of intent to levy against the estate. After repeated requests to pay the estate tax and only partial payments made by the defendants, on July 24, 2013, the IRS filed a Notice of Federal Tax Lien in the county in which Arshem owned real estate.

The government then filed this proceeding to seek judgments against each defendant for unpaid estate tax, penalties and interest under IRC § 6324(a)(2). After the defendants responded, the government moved for summary judgment. Only one of the defendants, Donna Ringling, opposed the motion.

IRC § 6324(a)(2) provides that, if a federal estate tax is not paid when due, a transferee, surviving tenant or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under IRC §§ 2034-2042, is personally liable for such tax. Each recipient is liable based on the property the recipient received from the decedent, to the extent of the property's value measured at the time of the decedent's death.

The court concluded that the defendants were liable under IRC § 6324(a)(2). The estate tax was not paid when due and each defendant received property includible in the gross estate under IRC §§ 2034-2042. Certain assets, purchased by Arshem, were owned jointly by Arshem and the defendants at Arshem's death, causing inclusion in Arshem's gross estate under IRC § 2040. Arshem owned life insurance policies on his life, includible in his gross estate under IRC § 2042. Some of the defendants were beneficiaries of those policies. Arshem forgave debts owed by some of the defendants within three years of his death. The forgiveness of these debts constituted gifts includible in his gross estate under IRC § 2035. Arshem also transferred real estate to one of the defendants and retained a life estate, causing such real estate to be included in his gross estate under IRC § 2036 upon his death.

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Ringling asserted various defenses in an attempt to resist summary judgment, including accord and satisfaction, waiver, estoppel and statute of limitations. To avoid summary judgment, the court explained that Ringling "may not 'rest on mere allegations or denials, but must demonstrate on the record the existence of specific facts which create a genuine issue for trial.'" *Quoting Mosely v. City of Northwoods*, 415 F.3d 908 (8th Cir. 2005). The court found that Ringling did not meet her burden to withstand summary judgment because she failed to identify any specific facts in the record that supported her defenses.

D. Tenth Circuit Rules That Government Not Time-Barred on Claim to Collect Estate Taxes From Beneficiaries

United States v. Johnson, 920 F.3d 649 (10th Cir. March 29, 2019)

Hazel Anna S. Smith died on September 2, 1991. A substantial portion of her estate consisted of shares in a closely held corporation that held a Nevada gaming license. The successor Trustees of her trust filed a federal estate tax return on June 1, 1992. The successor Trustees paid part of the estate taxes due and made an election under IRC § 6166(a) to pay the remaining liability in installments until June 2, 2006. The IRS assessed the estate for unpaid estate taxes on July 13, 1992.

Even though the assessed estate tax remained unpaid, the successor Trustees distributed the stock to the beneficiaries on December 31, 1992. This distribution was motivated by state law restrictions on a trust owning a casino. The trust beneficiaries signed an agreement (the "Distribution Agreement") under which they agreed to be liable for the unpaid estate tax liability.

The estate ceased making payments of estate taxes in 2002. The IRS declared the installment agreement in default as of December 18, 2003.

In 2011, the government filed a complaint to collect the unpaid tax liability from the trust beneficiaries. The government sought to enforce rights as a third-party beneficiary of the Distribution Agreement. The government also asserted the trust beneficiaries were liable for estate taxes under IRC § 6324(a)(2) due to the inclusion of life insurance proceeds in the gross estate under IRC § 2042. IRC § 6324(a)(2) generally provides that a recipient of property included in a decedent's gross estate is personally liable for the estate tax to the extent of the date-of-death value of the property received. The trust beneficiaries asserted that the government's claim under IRC § 6324(a)(2) was time-barred. The government first learned of the Distribution Agreement in June 2005 and did not assert a claim under this agreement until it filed an amended complaint in August 2012.

The United States District Court for the District of Utah found that the government's claim under the Distribution Agreement was time-barred because it was subject to Utah's six-year statute of limitations. The District Court also found that the government's transferee-liability claim under IRC § 6324(a)(2) was not barred by the statute of limitations.

On appeal, the United States Court of Appeals for the Tenth Circuit concluded that the claim under the Distribution Agreement is governed by the statute of limitations under IRC § 6502(a), which provides a ten-year statute of limitations for actions brought to collect assessed taxes. The Tenth Circuit found that its own precedent and Supreme Court precedent dictated this

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result because the government is always acting in its sovereign capacity when it seeks to collect unpaid federal taxes. *United States v. Summerlin*, 310 U.S. 414 (1940); *United States v. Holmes*, 727 F.3d 1230 (10th Cir. 2013). It is immaterial whether the government's claim arises under federal or state law.

The Tenth Circuit agreed with the District Court that the government's transferee-liability claim under IRC § 6324(a)(2) was timely filed. The ten-year statute of limitations under IRC § 6502(a) applies to claims under IRC § 6324(a)(2) as well. The statute of limitations was suspended due to the election under IRC § 6166. IRC § 6503(d). The statute of limitations did not begin to run until the IRC § 6166 election terminated on December 15, 2003. Thus, when the government filed its claim under IRC § 6324(a)(2) on January 21, 2011, it was within the statute of limitations.

XI. LIFE INSURANCE

A. IRS Issues Proposed Regulations on the Transfer for Value Rules and Reportable Policy Sales

REG-103083-18 (March 25, 2019)

The IRS has issued proposed regulations on information reporting for certain life insurance transfers and modifications to the transfer for value rules. These proposed rules are not only relevant to life settlements, but also other transfers of life insurance policies, such as transfers to fund buy-sell agreements.

1. Reportable Policy Sale. Primarily, the proposed regulations deal with "reportable policy sales." The 2017 Tax Act added IRC § 101(a)(3), which states that the exceptions to the transfer for value rule (*i.e.*, the related party exception and the carryover basis exception summarized above) will not apply if a transfer of a life insurance policy for valuable consideration is a reportable policy sale, defined as "the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract." Prop. Reg. § 1.101-1(c)(1). In addition, as described briefly below, various reporting requirements apply when a life insurance policy is the subject of a reportable policy sale. IRC § 6050Y. Unlike many other provisions of the 2017 Tax Act, the above provisions added by the 2017 Tax Act do not sunset after 2025.

An "indirect" acquisition of a life insurance policy includes "the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract." IRC § 101(a)(3)(B). "Other entity" in this definition does not include a C corporation unless more than 50% of the gross value of its assets consists of life insurance contracts. Prop. Reg. § 1.101-1(e)(3)(ii); *see also* Prop. Reg. § 1.101-1(c)(2)(iii); -1(g)(10), (12).

"An interest in a life insurance contract" is broadly defined as "the interest held by any person that has taken title to or possession of the life insurance contract (also referred to as a life insurance policy), in whole or part, for state law purposes, including any person that has taken title or possession as nominee for another person, and the interest held by any person that has an enforceable right to receive all or a part of the proceeds of a life insurance contract or to any other

economic benefits of the policy as described in §20.2042-1(c)(2) of this chapter, such as the enforceable right to designate a contract beneficiary." Prop. Reg. § 1.101-1(e)(1).

The proposed regulations broadly define a substantial family, business or financial relationship for purposes of determining whether a transfer constitutes a reportable policy sale. Notably, a substantial family relationship would exist between an individual and his or her former spouse with regard to a transfer of an interest in a life insurance policy to (or in trust for the benefit of) that former spouse incident to divorce. Prop. Reg. § 1.101-1(d)(1). In addition, the definition of substantial business relationship would exclude from the definition of reportable policy sales the acquisition in the ordinary course of business of an entity that holds life insurance policies on its employees. Prop. Reg. § 1.101-1(d)(2), (4); -1(g)(11); *See* Gorin, Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications, Part II.Q.4.b.ii. (2nd Quarter, 2019).

2. <u>Modifications to Transfer for Value Rule Exceptions</u>. Prop. Reg. § 1.101-1(b)(1)(ii)(A) would modify the carryover basis exception to the transfer for value rule in IRC § 101(a)(2)(A) and Treas. Reg. § 1.101-1(b)(1), summarized above. This provision would prescribe that the limitation in IRC § 101(a)(2) (*i.e.*, limiting the exclusion from gross income to the amount of consideration paid and the premiums and other amounts subsequently paid by the transferee) would not apply to the transfer of a life insurance policy for valuable consideration if: (a) the transfer is not a reportable policy sale; (b) the basis of the interest transferred for the purpose of determining gain or loss with respect to the transferee is determinable in whole or in part by reference to the basis of that interest in the hands of the transferor; and (c) the following rule, Prop. Reg. § 1.101-1(b)(1)(ii)(B), does not apply to the transfer. However, the amount of proceeds from a policy transferred for valuable consideration, even if it does meet the requirements of this Prop. Reg. § 1.101-1(b)(1)(ii)(A), would be limited to the sum of: (a) the amount that would have been excludable by the transferor and (b) the premiums and other amounts subsequently paid by the transferee. In the case of a transfer of a life insurance policy from the original policyholder, this limitation on the amount excludable would have no effect because, if the life insurance policy had remained with the transferor, all of the death proceeds would have been excludable from gross income. *See* Gorin, *supra*.

Prop. Reg. § 1.101-1(b)(1)(ii)(B) would modify the related party exception to the transfer for value rule in IRC § 101(a)(2)(B) and Treas. Reg. § 1.101-1(b)(1), summarized above. This provision would prescribe that the limitation in IRC § 101(a)(2) (*i.e.*, limiting the exclusion from gross income to the amount of consideration paid and the premiums and other amounts subsequently paid by the transferee) would not apply to the transfer of a life insurance policy for valuable consideration if: (a) the transfer is not a reportable policy sale and the interest was not previously transferred for valuable consideration in a reportable policy sale and (b) the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer.

3. <u>Gratuitous Transfers</u>. The proposed regulations also address the taxation of proceeds from life insurance policies that were transferred by gift (including gratuitous transfers that are reportable policy sales). The amount of the proceeds attributable to the interest that is excludable from gross income under IRC § 101(a)(1) would be limited to the sum of: (a) the amount of the proceeds attributable to the gratuitously-transferred interest that would have been

excludable by the transferor if the transfer had not occurred and (b) the premiums and other amounts subsequently paid by the transferee. Prop. Reg. § 1.101-1(b)(2)(i). The preamble to the proposed regulations explains that, although Treas. Reg. § 1.101-1(b)(2), discussed above, provides a special rule for gratuitous transfers made by or to the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer, such a rule is not required by IRC § 101(a) and the proposed regulations do not contain a special rule for these transfers because it could be subject to abuse.

4. Cleansing a Tainted Policy. The examples in the proposed regulations show that, for sales that are not reportable policy sales, if the initial sale was a transfer for value, a sale back to the insured will cause the death proceeds to avoid the transfer for value rule. However, a gift back to the insured in this situation would not remove the death proceeds from the transfer for value rule. For sales that are reportable policy sales, no transfer back to the insured will remove the death proceeds from the transfer for value rule. *See* Gorin, *supra*.

5. Reporting Requirements for Reportable Policy Sales. When a sale of a life insurance policy constitutes a reportable policy sale, the proposed regulations would also provide rules concerning the reporting requirements under IRC § 6050Y. The reporting requirements are imposed on the acquirer of the life insurance policy. The acquirer must provide written statements to those who receive payments under a reportable policy sale and to the issuer of the life insurance policy. Prop. Reg. § 1.6050Y-2(a). The payment recipients will then use the written statement to determine the amount of the payment received that constitutes taxable income. *See* Leimberg, LISI Income Tax Planning Newsletter #178 (March 25, 2019) at http://www.leimbergservices.com. The acquirer must furnish the written statement to the payment recipient on or before February 15 of the year following the year in which the reportable policy sale occurred. Prop. Reg. § 1.6050Y-2(d)(1)(ii).

The acquirer need not provide a written statement to an issuer in an indirect acquisition. Prop. Reg. § 1.6050Y-2(d)(2)(i)(B). Exceptions would apply to acquirers that are foreign persons. Prop. Reg. § 1.6050Y-2(f).

6. Applicability. The proposed regulations would apply to reportable policy sales made after December 31, 2017. For any other purpose, the proposed regulations apply to transfers of life insurance policies, or interests in policies, made after the date that the proposed regulations are finalized and published in the Federal Register.

7. Employer-Owned Life Insurance Contracts. The proposed regulations would update Treas. Reg. § 1.101-1(a)(1) to reflect the enactment of IRC § 101(j) in 2006 by simply stating that the amount excluded from gross income under IRC § 101(a) may be affected by IRC § 101(j). Prop. Reg. § 1.101-1(b)(1)(i).

IRC § 101(j) is the primary provision dealing with the taxation of employer-owned life insurance ("EOLI") contracts. In general, this subsection provides that death proceeds paid under an EOLI contract are included in gross income to the extent such proceeds exceed the premiums and other amounts paid by the applicable policyholder, unless certain exceptions are met. IRC § 101(j)(1). Any proceeds in excess of those two amounts will be subject to tax at ordinary income

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rates. Leimberg, LISI Estate Planning Newsletter #1467 (May 22, 2009) at http://www.leimbergservices.com (hereinafter, Leimberg #1467).

An "employer owned life insurance contract" is defined as a life insurance contract which: (a) is owned by a person engaged in a trade or business (irrespective of the type or size of the business) and under which such person or a related person is directly or indirectly a beneficiary under the contract; and (b) covers the life of the insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued. IRC § 101(j)(3)(A). A life insurance contract that is owned by a sole proprietor on his or her own life is not an EOLI contract. Leimberg #1467, *supra*. The term "applicable policyholder" essentially means the owner of the EOLI contract (as referenced in the first part of the definition of an EOLI contract) or a related person. IRC § 101(j)(3)(B).

a. <u>Exceptions to Taxation of Proceeds</u>. The statute provides for two exceptions to the general rule, meaning that, if the EOLI contract meets the requirements for one of these exceptions, then the entire amount of the death proceeds will be excluded from the policyholder's gross income under the general rule of IRC § 101(a)(1).

Any amount received by reason of the death of an insured who, with respect to an applicable policyholder: (1) was an employee at any time during the 12-month period before the insured's death; or (2) is, at the time the contract is issued, a director, a highly compensated employee (as defined in IRC § 414(q)) or individual (as defined in IRC § 105(h)(5), except that the individual must be among the top 35%, rather than the top 25%, of the highest paid employees), is not included in the policyholder's gross income. IRC § 101(j)(2)(A).

In addition, any amount received by reason of the death of the insured will not be includible in the policyholder's gross income to the extent that: (1) the amount is paid to a member of the family of the insured, any individual who is the designated beneficiary of the insured under the contract (other than the applicable policyholder), a trust established for the benefit of any such member of the family or designated beneficiary or the estate of the insured; or (2) the amount has been used to purchase an equity interest in the applicable policyholder from any person described in option (1). IRC § 101(j)(2)(B). The purchase of the equity interest must be paid by the due date, including extension, of the tax return for the taxable year of the applicable policyholder in which death benefit is received. Notice 2009-48, 2009-24 I.R.B. 1085, A-6.

To qualify for either of these exceptions, however, the notice and consent requirements of IRC § 101(j)(4) must be met. Before the issuance of the EOLI contract, the employee must be notified in writing that the applicable policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued. In addition, the employee must provide written consent to being insured under the contract and that such coverage may continue after the insured terminates employment. Finally, the employee must be informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.

For purposes of IRC § 101(j)(2)(A) and (j)(4), an EOLI contract is treated as "issued" on the later of: (1) the date of application for coverage, (2) the effective date of coverage or (3) the formal issuance of the contract. The IRS has stated that an inadvertent failure to satisfy the notice

and consent requirements may not prohibit the application of one of the exceptions under IRC § 101(j)(2). Notice 2009-48, 2009-24 I.R.B. 1085, A-4, A-13.

b. **Definition of Employee.** Another important limitation to the application of IRC § 101(j) is the definition of an employee, which only includes an officer, director and a highly compensated employee (within the meaning of IRC § 414(q)). IRC § 101(j)(5)(A). Under IRC § 414(q), a former employee is treated as a highly compensated employee if the individual was a highly compensated employee when he or she separated from service or was a highly compensated employee at any time after attaining age 55. Leimberg #1467, *supra.*

c. **Annual Filing Requirements.** Every applicable policyholder that owns one or more EOLI contracts issued after August 17, 2006 must file Form 8925 setting forth specific information for each year the contracts are owned. IRC § 6039I; Leimberg #1467, *supra*.